Report No. 1307

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE PROPOSED REGULATIONS ON THE ALLOCATION OF PARTNERSHIP LIABILITIES AND DISGUISED SALES

May 30, 2014

Table of Contents

New York State Bar Association Tax Section

Report on the Proposed Regulations on the Allocation of Partnership Liabilities and Disguised Sales

Introduction

This report[1] of the Tax Section of the New York State Bar Association provides comments on regulations proposed on January 30, 2014 (the "Proposed Regulations") concerning the allocation of partnership liabilities under section 752 and disguised sales under section 707.[2]

This report is divided into four parts. Part I provides a summary of our recommendations. Part II provides a summary of current law and the Proposed Regulations. Part III contains a detailed discussion of our recommendations regarding the Proposed Regulations under section 752. Finally, Part IV contains a detailed discussion of our recommendations regarding the Proposed Regulations under section 707.

I. Summary of Principal Recommendations

1. ***First,*** we recommend that:

a. The IRS and Treasury should consider treating all liabilities as nonrecourse solely for purposes of the disguised sale rules.

Under this approach, a partner's allocable share of a partnership liability (including a liability assumed or taken subject to by the partnership in connection with the contribution of property by the partner to the partnership) would equal the portion of the liability that would be allocated to the partner if the entire liability were allocable among the partners under the provisions of Treas. Reg. § 1.752-3(a)(3) (but excluding for this purpose the Significant Item Method and the Alternative Method (both of which are defined below)); *provided*, *however*, that the partner's allocable share of

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[1] The principal authors of this report are Eric B. Sloan, Matthew W. Lay, and Krista M. Lindhard. Significant contributions were made by Phillip Gall, Michael L. Schler, and David H. Schnabel. Helpful comments were received from Stephen P. Foley, Elizabeth Kessenides, Stephen B. Land, and David R. Sicular. This report reflects solely the views of the Tax Section of the New York State Bar Association (the "NYSBA") and not those of the NYSBA Executive Committee or House of Delegates.

[2] REG-119305-11, 79 Fed. Reg. 4826 (Jan. 30, 2014). Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

any such liability should not include any portion of the liability with respect to which another partner bears the economic risk of loss).

b. The provisions of the Proposed Regulations relating to recourse liabilities under section 752 that should be finalized should be limited to:

i. The provisions limiting bottom-dollar guarantees in Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) and (G), as modified by recommendation #3. If, however, it is determined that doing so would result in significant changes to the manner in which partnership deductions are allocated under section 704(b) (applying traditional section 704(b) principles), we recommend that the IRS and Treasury consider seeking additional public comments before finalizing those provisions.

ii. The provisions expanding the application of the net value rule of Treas. Reg. § 1.752-2(k), as modified by recommendation #4. If, however, the approach described in recommendation #1(a) is adopted, the IRS and Treasury should consider whether the benefits of expanding the net value rule are outweighed by the administrative difficulties the expansion is likely to create for both taxpayers and the IRS and whether it would be preferable simply to expand the anti-abuse rule currently found in Treas. Reg. § 1.752-2(j).

2. ***If recommendation #1 is not accepted***, we have the following alternative recommendations:

a. ***Solely for disguised sale purposes*** (and not for purposes of allocating liabilities among partners under section 752), we would recommend that the final regulations:

i. Prevent all bottom-dollar guarantees by adopting the requirements in Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) and (G).

ii. Impose minimum net worth requirements on all partners and related persons, including individuals and decedents' estates.

iii. Prohibit the use of the Significant Item Method and the Alternative Method.

b. ***Regarding payment obligations in general***, we would recommend that the final regulations provide that only payment obligations that contain terms that are reasonably consistent with customary commercial practices for similar arrangements among unrelated third parties will be given effect under the section 752 regulations. For this purpose, the final regulations should contain a nonexclusive list of facts and circumstances that would be relevant in determining whether this requirement was satisfied and should provide that no single factor is determinative. *(Recommendation #2(c), below, is included in the event that this recommendation #2(b) is not accepted.)*

c. ***Regarding the specific requirements for payment obligations***, we would recommend that:

i. The final regulations should provide guidance regarding the consequences of a credit support provider's breach of its contractual obligations with regard to the requirements under Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A), which would require the credit support provider (i) to maintain a commercially reasonable net worth throughout the term of the payment obligation; or (ii) to be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration. Similar guidance should be provided regarding Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(B), which would require the credit support provider periodically to provide commercially reasonable documentation regarding the credit support provider's financial condition.

ii. The final regulations should not include the requirement of Prop. Treas. Reg. § 1.752-2(b)(ii)(C) that "[t]he term of the payment obligation does not end prior to the term of the partnership liability."

iii. The final regulations should not include a requirement that the partner or related person receive arm's length consideration for assuming or entering into a payment obligation. In addition, we recommend that the final regulations make clear that the failure of a credit support provider to be paid for providing the credit support is not a factor to be taken into account in determining whether the credit support is a bona fide commercial arrangement that will be recognized under the final regulations.

3. Although we generally support the provisions of the Proposed Regulations preventing ***"bottom-dollar" guarantees***, we recommend the following modifications:

a. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) and (G) should be combined into a single paragraph. (For convenience, we will refer to those two paragraphs as Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F).)

b. The final regulations should contain an anti-abuse rule to address "tranched" debt and similar arrangements that, for purposes of applying Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F), would treat two or more liabilities as a single liability if –

i. The liabilities are incurred either pursuant to a common plan or as part of a single transaction or a series of related transactions,

ii. The liabilities have the same counter-party or counter-parties (or substantially the same group of counter-parties),

iii. The guarantee or similar arrangement being tested would fail to satisfy the requirements of Prop. Treas. Reg. § 1.752-3(b)(3)(ii)(F) if the liabilities were treated as a single liability, and

iv. Multiple liabilities (rather than a single liability) were incurred with a principal purpose of avoiding Prop. Treas. Reg. § 1.752-3(b)(3)(ii)(F).

c. The final regulations should recognize "vertical slice" guarantees.

d. The final regulations should retain the rule of the Proposed Regulations that would provide that a payment obligation will not be recognized unless the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Nevertheless, the final regulations should provide that a payment obligation will be respected if a partner or related person (i) is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, less than 80 percent of the partnership liability is not otherwise satisfied and (ii) either (A) the taxpayer or the IRS clearly establishes that the credit support materially decreased the partnership's borrowing costs with respect to the liability or materially enhanced the other terms of the borrowing or (B) the partners (or persons related to one or more of the partners), in the aggregate, are or would be liable up to the full amount of their payment obligations if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

e. The final regulations should make it clear that a deficit restoration obligation is treated as a guarantee or similar arrangement for purposes of Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F).

4. ***Regarding the net value rules***, we recommend that:

a. The net value rule of Treas. Reg. § 1.752-2(k) should be extended to all partners and related persons other than individuals.

b. The net value rules should be consolidated in Treas. Reg. § 1.752-2(k) by extending the net value rules to all partners and related persons (other than individuals) rather than retaining the framework of the Proposed Regulations (which initially assume that all parties will satisfy their obligations regardless of their net worth, would have a special rule for disregarded entities, and then would treat certain partners and related persons as disregarded entities).

c. The rule in Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(C), which would require that the partner who may be treated as bearing the economic risk of loss for a partnership liability provide information regarding the net value of the credit support provider, should be modified to require instead that the partner be required to make a representation regarding the net value of the credit support provider. If a partner fails to provide the required representation, the credit support provider would be treated as having a net worth of zero.

d. The portion of the final regulations addressing the application of the net value rules should include an anti-avoidance provision similar to Treas. Reg. § 1.705-2(c)(1), which provides that the purpose of those regulations "cannot be avoided through the use of tiered partnerships or other arrangements."

5. ***Regarding the reimbursement rule*** in Prop. Treas. Reg. § 1.752-2(b)(1), we recommend that:

a. The final regulations should provide that the rule does not apply to a right to be reimbursed by the partnership or by a person related to the person who has a right to be reimbursed.

b. The final regulations should clarify the extent to which the rule would apply if the partnership obtains credit support that is intended to (or has the effect of) reducing a credit support provider's economic risk with respect to one or more partnership liabilities.

6. ***The special rule under Treas. Reg. § 1.752-2(e)*** (and related Treas. Reg. § 1.752-2(f), *Example 7*) should remain unchanged.

7. ***Regarding the allocation of nonrecourse liabilities***, we recommend the following:

a. If the concern motivating the proposed changes to Treas. Reg. § 1.752-3(a)(3) is the attempt by taxpayers and their advisors to exploit those methods in the context of the disguised sale rules, the final regulations should take a more narrowly tailored approach, specifically leaving Treas. Reg. § 1.752-3(a)(3) as it is, but (i) adding the proposed liquidation value percentage rules as a permissible method for all purposes, and (ii) prohibiting the use of the Significant Item Method and the Alternative Method for purposes of the disguised sale rules. If, on the other hand, the motivating concern is that the Significant Item Method permits the allocation of nonrecourse liabilities in a manner that is inconsistent with the partners' shares of partnership profits, the IRS and Treasury should revisit Treas. Reg. § 1.704-2(e)(2), which permits "allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities."

b. The final regulations should permit partnerships to allocate excess nonrecourse liabilities *either* in accordance with partnership profits as reasonably determined by the partnership *or* in accordance with the partners' liquidation value percentages. In addition, the final regulations should make clear that, for purposes of determining the partners' interests in partnership profits, the partnership may rely on a reasonable estimate of the amounts the partners are expected to receive from the partnership over the life of the partnership. The partnership should be required to revise its estimates each year and should be permitted to do so more frequently, in each case using consistent valuation and liquidation assumptions to the extent doing so is reasonable in light of the facts and circumstances.

c. The final regulations should not require hypothetical revaluations of the partners' capital accounts for purposes of determining a partner's liquidation value percentage under Prop. Treas. Reg.

§ 1.752-3(a)(3). Instead, the final regulations should follow the approach of the regulations under section 706, which permit partnerships to "assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts as of the first day of the partnership taxable year."

8. ***Regarding transition rules in the final regulations under section 752***, we recommend the following:

a. The final regulations should permit partnership liabilities that are modified and/or refinanced and payment obligations that are modified to continue to be subject to the provisions of the existing regulations, but only to the extent of the amount and duration of the pre-modification (or refinancing) liability or payment obligation.

b. Partnerships should be permitted to elect to apply all, but not less than all, of the provisions of the final regulations under section 752 to all of its liabilities and payment obligations with respect to its liabilities.

9. ***Regarding disguised sales of property by partners to partnerships***, we recommend that:

a. The final regulations should add limited aggregation rules to Prop. Treas. Reg. § 1.707-4(d)(1)(ii)(B), which (as proposed) would provide that the limitation on the preformation capital expenditure exception applies on a "property-by-property" basis.

b. The rule in Prop. Treas. Reg. § 1.707-4(d)(2) that would limit the reimbursement of debt-financed preformation capital expenditures should be broadened to apply the same rule to capital expenditures funded by any qualified liability, rather than applying that rule only to liabilities that are qualified liabilities by reason of those capital expenditures.

i. For this purpose, capital expenditures should be treated as "funded by" the proceeds of a particular qualified liability to the extent (i) the proceeds of the liability are traced under Temp. Treas. Reg. § 1.163-8T to the capital expenditures or (ii) the proceeds actually were used to fund the capital expenditures, regardless of whether the timing requirements of Temp. Treas. Reg. § 1.163-8T are satisfied.

ii. The final regulations should include a broadly drafted anti-abuse rule that would apply if planning is undertaken with respect to a liability and capital expenditures with a principal purpose of circumventing the purposes and requirements of Prop. Treas. Reg. § 1.707-4(d)(2).

c. The final regulations should clarify that a partner's share of the liability in Prop. Treas. Reg. § 1.707-4(d)(2) should be determined under Treas. Reg. § 1.707-5(a)(2), taking into account the anticipated reduction rule in Treas. Reg. § 1.707-5(a)(3).

d. The final regulations should confirm that if property is transferred in a nonrecognition transaction, and the transferee assumes a qualified liability of the transferor or takes the property subject to a qualified liability, the liability retains its status as a qualified liability in the hands of the transferee. Similarly, the final regulations should confirm that if a taxpayer incurs preformation capital expenditures with respect to property and transfers the property in a nonrecognition transaction, the transferee succeeds to the status of the transferor with respect to those expenditures.

e. The final regulations should provide that, in an assets-over partnership merger, qualified liabilities of one or more partners in a terminating partnership that are assumed or taken subject to by the continuing partnership will be treated as qualified liabilities of the terminating partnership for purposes of applying the disguised sale rules to the merger.

10. ***Regarding disguised sales of property by partnerships to partners***, we recommend that:

a. The final regulations should add to Treas. Reg. § 1.707-6 an "increase in anticipation of transfer" rule similar to the anticipated reduction rule of Treas. Reg. § 1.707-5(a)(3). (Like its counterpart in Treas. Reg. § 1.707-5, the rule in Treas. Reg. § 1.707-6 would be applicable only to nonqualified liabilities.)

b. The final regulations should provide that (i) if a partnership incurs a liability in anticipation of distributing an asset to a partner subject to the new liability, and (ii) the partnership retains the proceeds of the liability (or distributes the proceeds to another partner), the new liability assumed or taken subject to by the distributee partner is treated as consideration for the sale of property to the partner to the extent the liability assumed or taken subject to by the distributee partner exceeds any associated decrease in the partner's share of pre-existing partnership liabilities remaining in the partnership.

II. Summary of Current Law and Proposed Regulations

A. Current Regulations on the Allocation of Partnership Liabilities

1. History of Regulations

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's liabilities by reason of the assumption by that partner of partnership liabilities, is considered a contribution of money by the partner to the partnership.[3] Conversely, section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of those individual liabilities, is considered a distribution of money by the partnership to that partner.[4]

The regulations under section 752 provide rules for determining a partner's share of partnership liabilities. In 1956, the Treasury promulgated the first set of regulations under section 752 (the "<u>1956 Regulations</u>").[5] The 1956 Regulations provided that:

> A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners has any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.[6]
>
> In determining the amount of liabilities for the purposes of section 752 and this section, the amount of an indebtedness is to be taken into account only once, even though a partner (in addition to his liability for such indebtedness as a partner) may be separately liable therefore in a capacity other than as a partner.[7]

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3 Section 752(a); Treas. Reg. § 1.752-1(b).

4 Section 752(b); Treas. Reg. § 1.752-1(c).

5 This discussion of the history of the regulations under section 752 is taken from Eric Sloan and Jennifer Alexander, *Economic Risk of Loss: The Devil We Think We Know*, 84 Taxes 239 (Mar. 2006).

6 Former Treas. Reg. § 1.752-1(e).

7 Former Treas. Reg. § 1.752-1(f).

Thus, the 1956 Regulations adopted a general rule with two exceptions. Under the general rule, a partner's share of partnership liabilities was determined in accordance with the partner's ratio for sharing losses under the partnership agreement, regardless of whether the general partners had contributed equal amounts of capital. The first exception, applicable to limited partnerships, provided that a limited partner's share of partnership liabilities could not exceed the difference between the partner's actual contributions to the partnership and the total contributions the partner was obligated to make under the partnership agreement. The second exception addressed those liabilities for which no partner bore any personal liability. In those situations, a partner's share of such liability was determined in accordance with the partner's ratio for sharing partnership profits.

In 1983, the United States Claims Court, in *Raphan*,[8] held that the *general partner's* guarantee of a nonrecourse liability of a limited partnership did not preclude the limited partners from sharing in the liability for purposes of section 752. In *Raphan*, the general partner guaranteed a nonrecourse liability of the partnership, but the guarantee was not part of the partnership agreement; rather, it was an agreement between the general partner and the lender. In reaching its conclusion, the Claims Court stated that, under the 1956 Regulations, "the benchmark for determining a partner's step up in basis is the partnership agreement."[9] Because the guarantee was not part of the partnership agreement, it did not affect the allocation of partnership liabilities.

In addition, the Claims Court noted that the Code generally and the 1956 Regulations in particular recognized that a partner may deal with his partnership in a capacity other than that of a partner.[10] Specifically, the court noted that the:

> tax treatment of partnership gains and losses turns on the partners' rights and responsibilities *as partners*, which are governed by the partnership agreement and by partnership law. Partners may act *vis-a-vis* the partnership in capacities other than as partners, *e.g.*, as employees, creditors or lessors. 26 U.S.C. § 707(a) (1976). There is no reason a partner cannot assume liability for partnership debts in a capacity other than as a partner.[11]

Because the general partner's liability did not run directly to the partnership and was not provided for in the partnership agreement, the Claims Court held that the general partner was "securing rights and assuming responsibilities which are separate from, and independent of, his

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8 *Raphan v. United States*, 3 Cl. Ct. 457 (1983), *aff'd in part and rev'd in part*, 759 F.2d 879 (Fed. Cir. 1985).

9 *Raphan*, 3 Cl. Ct. at 465.

10 *See* Former Treas. Reg. § 1.752-1(f) ("the amount of an indebtedness is to be taken into account only once, even though a partner (in addition to his liability for such indebtedness as a partner) may be separately liable therefore in a capacity other than as a partner").

11 *Raphan*, 3 Cl. Ct. at 465.

role as a partner."[12] Thus, the liability was allocated as if no partner had personal liability for the loan, *i.e.*, in accordance with the partners' profit ratios.

Shortly after the *Raphan* decision, the IRS published a revenue ruling reaching a different conclusion. In Rev. Rul. 83-151,[13] the IRS concluded that, if a general partner guarantees an otherwise nonrecourse partnership liability, the limited partners may not share in the liability for purposes of section 752. In so concluding, the IRS specifically held that a nonrecourse loan guaranteed by a general partner is an obligation for which the general partner is personally liable.[14] The following year, Congress reacted to the government's loss in *Raphan* by directing the Treasury to promulgate regulations that would ensure that "the partner receiving the basis with respect to a partnership liability bears (to the extent possible) the economic risk of loss with respect to such liabilities … and [to] reject the holding of the *Raphan* decision."[15] Specifically, the Conference Committee Report to the Tax Reform Act of 1984 (the "1984 Act") provided that:

> The decision in the *Raphan* case is not to be followed for purposes of applying section 752 or the regulations thereunder. In addition, the Treasury is to revise and update its regulations under section 752 (as soon as practicable) to take account of current commercial practices and arrangements, such as assumptions, guarantees, indemnities, etc. The conferees intend that the new regulations will reject the holding of the *Raphan* decision effective March 1, 1984, and that other changes in the regulations will apply prospectively from the date new regulations are proposed or some later date specified by the Treasury. The conferees do not intend that any inference should be drawn regarding the validity of the *Raphan* decision for transactions prior to March 1, 1984, and the conferees to do intend to affect in any way the rights of the various parties to that case. Finally, the conferees intend that the revisions to the section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to partnership debt (other than bona fide nonrecourse debt, as defined by such regulations). With respect to *bona fide* nonrecourse debt, the conferees do not expect that such regulations will make major changes to the manner in which the partners' shares are determined, but may attempt to

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12 *Id.*

13 1983-2 C.B. 105.

14 Note, however, that the IRS did not address the possibility that the general partner was acting in a capacity other than that of a partner. For a brief discussion, see Philip F. Postlewaite and Tammy Jo Bialosky, *Liabilities in the Partnership Context—Policy Concerns and the Forthcoming Regulations*, 33 UCLA L. REV. 733, 756-57 (1986). The government appealed the Claims Court's decision in *Raphan*. On appeal, the Court of Appeals for the Federal Circuit stated that the general partner was clearly acting in his capacity as a partner. *Raphan*, 759 F.2d at 885.

15 H.R REP. NO. 98-432, Pt. 2, at 1235.

> provide more certainty than presently exists.[16]

> The House Committee Report to the 1984 Act had gone further, stating that:

> The committee believes the holding in *Raphan* v. *United States* results in an inappropriate increase in the limited partners' basis in their interests. The committee also believes the rules for sharing partnership liabilities under the Treasury regulation sec. 1.752-1(e) [*sic*] are outdated and require revision to ensure that the partner receiving the basis with respect to a partnership liability bears (to the extent possible) the economic risk of loss with respect to such liabilities. Similarly, the committee is concerned with the lack of definition of when an "assumption" takes place under section 752.
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> The bill directs the Treasury Department to prescribe regulations regarding the conditions under which recourse and nonrecourse liabilities may be reflected in the basis of the partners' partnership interests. It is anticipated that these regulations among other things will reflect the position taken in Revenue Ruling 83-151 and will reject the holding in *Raphan v. United States*. Thus, the regulations will specify that indebtedness (or portion thereof) for which a general partner is primarily or secondarily liable (whether in his capacity as a partner or otherwise) is not a nonrecourse liability providing additional basis for limited partners' interests in a partnership. Similarly, when a limited partner guarantees a liability, the regulations will not shift the basis attributable to that liability away from the limited partner as a result of the guarantee. The committee does not intend that the regulations will alter the general rule allowing nonrecourse liabilities to be included in the basis of limited partners' interests.[17]

In response to Congress's mandate, Treasury issued temporary regulations under section 752 in 1988.[18] The current version of these regulations was finalized in 1991.[19] Under those regulations, recourse and nonrecourse liabilities are allocated under separate rules. A partnership liability is a recourse liability to the extent that any partner or related person bears the

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[16] H.R. CONF. REP. NO. 98-861, at 869.

[17] H.R. REP. NO. 98-432, Pt. 2, at 1235.

[18] T.D. 8237, 53 Fed. Reg. 53140 (Dec. 30, 1988).

[19] T.D. 8380, 56 Fed. Reg. 66348 (Dec. 23, 1991). The regulations were amended by T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001) (liability netting rule added for partnership mergers), and T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005) (adding definition of "§ 1.752-1 liabilities" in connection with the promulgation of Treas. Reg. § 1.752-7 regarding contingent liabilities).

economic risk of loss ("EROL") for that liability under Treas. Reg. § 1.752-2.[20] Conversely, a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability.[21] The amount of a liability is taken into account only once.[22]

2. Allocation of Recourse Liabilities

Under Treas. Reg. § 1.752-2(a), a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the EROL. In general, a partner bears the EROL for a partnership liability to the extent that, upon a constructive liquidation of the partnership, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable.[23] The determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances at the time of the determination.[24] All statutory and contractual obligations relating to the partnership liability are taken into account, including obligations imposed by the partnership agreement, contracts outside the partnership agreement, and state law.[25] A partner also generally bears the EROL for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the EROL for the liability is not borne by another partner[26] or if the partner or a related person pledges property as security for the liability.[27]

In determining the extent to which a partner bears the EROL for a partnership liability, Treas. Reg. § 1.752-2 contains special rules for payment obligations of (i) a business entity that is disregarded as separate from its owner under section 856(i) (qualified REIT subsidiary), (ii) section 1361(b)(3) (qualified subchapter S subsidiary), or (iii) the check-the-box

[20] Treas. Reg. § 1.752-1(a)(1). This report accepts, without evaluation, that the proper touchstone for allocating recourse liabilities is how the partners and related persons bear the EROL with respect to partnership liabilities.

[21] Treas. Reg. § 1.752-1(a)(2).

[22] Treas. Reg. § 1.752-4(c).

[23] Treas. Reg. § 1.752-2(b)(1). The regulations deem the following events to occur simultaneously upon a constructive liquidation: (i) all of the partnership's liabilities become payable in full; (ii) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero; (iii) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors' right to repayment is limited solely to one or more assets of the partnership); (iv) all items of income, gain, loss, or deduction are allocated among the partners; and (v) the partnership liquidates. *Id*. A partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner. Treas. Reg. § 1.752-2(b)(5).

[24] Treas. Reg. § 1.752-2(b)(3).

[25] Treas. Reg. § 1.752-2(b)(3)(iii). It is generally understood by practitioners that the term "state law" includes all applicable jurisdictional law, including the laws of the federal government, municipalities, and foreign governments.

[26] Treas. Reg. § 1.752-2(c)(1).

[27] Treas. Reg. § 1.752-2(h).

regulations in Treas. Reg. §§ 301.7701-1 through 301.7701-3 (collectively, "disregarded entities" or "DREs"). Under these special rules, a payment obligation of a DRE generally is taken into account only to the extent of the net value of the DRE as determined under the rules of Treas. Reg. § 1.752-2(k) (the "Net Value Rules").

3. Allocation of Nonrecourse Liabilities

Under Treas. Reg. § 1.752-3, a partner's share of a nonrecourse liability of a partnership is determined under a three-tier system. Under the first tier, a portion of the nonrecourse liability is allocated to the partners in proportion to, but not in excess of, each partner's share of partnership minimum gain (as determined under Treas. Reg. § 1.704-2).[28] Under the second tier, any portion of the nonrecourse liability not allocated under the first tier is allocated to the partners in proportion to, but not in excess of, the amount of gain that would be allocated to each partner under section 704(c)(1)(A) if the partnership disposed of all partnership property that is subject to nonrecourse liabilities in full satisfaction of the liabilities and for no other consideration.[29]

Under the third tier ("Tier 3"), any portion of the nonrecourse liability not allocated under the first or second tiers generally is allocated to the partners in accordance with the partners' relative shares of partnership profits.[30] The partnership agreement may specify the partners' interests in the partnership profits for purposes of allocating liabilities not allocated under the first or second tiers ("excess nonrecourse liabilities"), provided that the interests so specified are reasonably consistent with allocations that have substantial economic effect of some other significant item of partnership income or gain (the "Significant Item Method"). Treas. Reg. § 1.752-3(a)(3) also provides generally that excess nonrecourse liabilities may be allocated to a partner based on the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (the "Alternative Method").[31] In

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[28] Treas. Reg. § 1.752-3(a)(1).

[29] Treas. Reg. § 1.752-3(a)(2). Section 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

[30] Treas. Reg. § 1.752-3(a)(3).

[31] Treas. Reg. § 1.752-3(a)(3) does not specify what deductions qualify as "deductions attributable to those nonrecourse liabilities." Treas. Reg. § 1.704-2(b)(1) uses nearly identical language – "losses, *deductions*, or section 705(a)(2)(B) expenditures *attributable to partnership nonrecourse liabilities* ('nonrecourse deductions')." While not entirely clear, it appears that these phrases in Treas. Reg. § 1.752-3(a)(3) and Treas. Reg. § 1.704-2 are co-extensive. That is, it appears that the two phrases were intended to have the same meaning, and, thus, for purposes of Treas. Reg. § 1.752-3(a)(3), "deductions attributable to those nonrecourse liabilities" would be limited to nonrecourse deductions as defined in Treas. Reg. § 1.704-2(b)(1). In that regard, the preambles to the proposed and final regulations under section 752 do not draw any distinction between the two phrases. T.D. 8237, 53 Fed. Reg. 53140 (Dec. 30, 1988) (proposed regulations); T.D. 8380, 56 Fed. Reg. 66348 (Dec. 23, 1991) (final regulations). Moreover, the text of Treas. Reg. § 1.704-2(b)(1) and the preamble to the final section 704 regulations (published four days after the final section 752 regulations) indicate that the two phrases are synonymous. T.D. 8385, 56 Fed. Reg. 66978, 66979 (Dec. 27, 1991) ("Accordingly, allocations of *deductions attributable to partnership nonrecourse liabilities (nonrecourse deductions)* cannot have substantial economic effect because the nonrecourse

addition, a partnership may allocate an excess nonrecourse liability to a partner up to the amount of section 704(c) gain that is allocable to the partner to the extent the gain has not already been taken into account under the second tier (the "Remaining 704(c) Method"). Importantly, the Remaining 704(c) Method is not available in allocating nonrecourse debt for purposes of the disguised sale provisions.

4. § 1.752-1 Liability Netting Rule

Treas. Reg. § 1.752-1(f) provides that if, as a result of a single transaction, a partner incurs both an increase in the partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of partnership liabilities (or the partner's individual liabilities), only the net increase or decrease is treated as a contribution to or distribution from the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability will require that increases or decreases in liabilities associated with the transaction be netted to determine if a partner is deemed to have made a contribution or received a distribution as a result of the transaction.[32] In addition, when two or more partnerships merge or consolidate under the assets-over form described in Treas. Reg. § 1.708-1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted "by the partners" in the terminating partnership and the resulting partnership to determine the effect of the merger under section 752. This rule (the "§ 1.752-1 Liability Netting Rule") is illustrated by the following example.[33]

> **Example 1**. (i) B owns a 70 percent interest in partnership T. Partnership T's only asset is property X, which is encumbered by a $900 liability. Partnership T's adjusted basis in property X is $600, and the value of property X is $1,000. B's adjusted basis in its partnership T interest is $420. B also owns a 20 percent interest in partnership S. Partnership S's only asset is property Y, which is encumbered by a $100 liability. Partnership S's adjusted basis in property Y is $200, the value of property Y is $1,000, and B's adjusted basis in its partnership S interest is $40.
>
> (ii) Partnership T and partnership S merge in an assets-over merger. Under section 708(b)(2)(A) and Treas. Reg. § 1.708-1(c)(1), partnership T is considered terminated, and the resulting partnership is considered a continuation of partnership S. Under Treas. Reg. § 1.708-1(c)(3)(i), partnership T is treated as contributing property X and its $900 liability to partnership S in exchange for an interest in partnership S. Immediately thereafter, partnership T is treated as distributing the interests in partnership S

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lender, rather than the partners, ultimately bears any economic loss attributable to those deductions." Emphasis added.).

[32] Treas. Reg. § 1.752-1(f).

[33] This example is based on Treas. Reg. § 1.752-1(g), *Example 2*.

> to its partners in liquidation of their interests in partnership T. After partnership T distributes the interests in partnership S to B, B owns a 25 percent interest in partnership S.
>
> (iii) Under Treas. Reg. § 1.752-1(f), B nets the increases and decreases in its share of partnership liabilities associated with the merger of partnership T and partnership S. Before the merger, B's share of the partnerships' liabilities was $650 (B had a $630 share of partnership T's liabilities and a $20 share of partnership S's liabilities immediately before the merger). B's share of partnership S's liabilities after the merger is $250 (25 percent of S's total partnership liabilities of $1,000). Accordingly, B has a $400 net decrease in its share of partnership S's liabilities. Thus, B is treated as receiving a $400 distribution from partnership S under section 752(b). Because B's adjusted basis in its partnership S interest before the deemed distribution under section 752(b) is $460 ($420 plus $40), B will not recognize gain under section 731(a). After the merger, B's adjusted basis in its partnership S interest is $60.

It is unclear whether the netting rule also protects partnership T, the terminated partnership, but Treas. Reg. § 1.752-1(g), *Example 2*, suggests that it does. Presumably for simplicity, all of the liability allocations in that example assume that the liabilities are allocated in proportion to the partners' economic interests. Accepting this convention,[34] partnership T's share of partnership S's liabilities immediately after partnership T was deemed to contribute property X to partnership S would have equaled 10 percent of those liabilities. Because the total amount of those liabilities is $1,000, partnership T's share of partnership S's debts would be $100. Partnership T's initial outside basis in its interest in partnership S is $600, its former basis in property X. This basis should have been reduced by $900 under section 752(b) when partnership S took property X subject to partnership T's $900 liability, and increased by $100 (partnership T's share of all of partnership S's liabilities immediately after the deemed contribution). In summary, if section 752(a) and (b) applied in the usual manner to partnership T's contribution of property to partnership S, then partnership T would have recognized $200 of gain under section 731(a) (the excess of $800 net decrease in liabilities over T's initial adjusted basis in S, $600). The example, though, makes no mention of partnership T's recognizing gain, and causing gain to be recognized would defeat the purpose of the § 1.752-1 Liability Netting Rule. For these reasons, it appears that the example illustrates that the effect of liabilities under section 752 is determined at the partner, rather than the terminating partnership, level in an assets-over merger. If Treasury and the IRS believe that the § 1.752-1 Liability Netting Rule does not protect the terminating partnership and that the terminating partnership needs to determine its share of the

[34] If the liability were allocated under the actual rules of section Treas. Reg. § 1.752-3, Partnership T could be allocated more of the liability and could avoid gain. For example, if T's historic liability were allocated to property X under Treas. Reg. § 1.752-3(b), then $300 of that liability would be allocated to T under Treas. Reg. § 1.752-3(a)(2).

liabilities in the continuing partnership, then the final regulations should revise example 2 of the current regulations.

B. The Code and the Current Disguised Sale Regulations

1. The Code

Section 707(a)(2)(B) generally provides that, under regulations, if:

(i) There is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) There is a related direct or indirect transfer of money or other property by the partnership to that partner (or another partner), and

(iii) The transfers described above, when viewed together, are properly characterized as a sale or exchange of property,

then the transfers will be treated as either occurring between a partnership and one who is not a partner, or between two or more partners acting other than in their capacity as members of the partnership.

Related transfers that are recast as a disguised sale may be recharacterized in one of three ways: (i) a disguised sale of property by a partner to the partnership, (ii) a disguised sale of property by a partnership to a partner, or (iii) a disguised sale of partnership interests between partners.

2. The Current Regulations – Generally

Treas. Reg. § 1.707-3 generally bases the determination of whether a transfer of property by a partner to a partnership, and a transfer of money or other consideration by the partnership to the partner constitute a disguised sale on "all the facts and circumstances."[35] Further, the regulations provide that a transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption or taking property subject to a liability) by the partnership to the

[35] The regulations provide a list of facts and circumstances used in determining whether a transfer of property by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale. Treas. Reg. § 1.707-3(b)(2). For two recent cases applying the disguised sales rules to a contribution of property to a partnership, see *Canal Corp., et al. v. Commissioner*, 135 T.C. 9 (Aug. 5, 2010) (holding that a joint venture transaction constituted a taxable disguised sale rather than a tax-deferred contribution to, and debt-financed distribution from, a partnership) and *G-I Holdings Inc. v. United States*, 105 A.F.T.R. 2d 2010-697 (D.N.J. Dec. 14, 2009) (finding that a loan to a partner was, despite the label and structure, in substance a loan to the partnership that was an indirect distribution by the partnership to the partner, which, when viewed together with the partner's contribution of assets to the partnership, resulted in a disguised sale of property by the partner to the partnership).

partner constitute a sale of property by the partner to the partnership only if, based on all the facts and circumstances: (1) the transfer of money or other consideration would not have been made but for the transfer of property; and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[36]

To provide more objectivity, the regulations contain rebuttable presumptions that transfers made within two years of each other constitute a sale, while transfers made more than two years apart are not a sale. Specifically, Treas. Reg. § 1.707-3(c) generally provides that, if within a two-year period, a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership, unless the facts and circumstances clearly establish that the transfers do not constitute a sale. Treas. Reg. § 1.707–3(d) generally provides that, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership are more than two years apart, the transfers are presumed *not* to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

3. Liabilities

Recognizing the economic equivalence between the transfer of cash from a buyer to a seller and the buyer's assumption of a seller's liabilities, the disguised sale regulations address a partnership's assumption of or taking property subject to a liability of a transferor partner. The regulations first divide liabilities into two broad categories – "qualified liabilities" and other, or nonqualified, liabilities.

If the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability.[37] For this purpose, the transferring partner's share of a recourse liability is determined under section 752 and the regulations promulgated under section 752.[38] A partner's share of a nonrecourse liability generally is determined by applying the same percentage used to determine that partner's share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3), with certain significant limitations.[39]

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36 Treas. Reg. § 1.707-3(b)(1).

37 Treas. Reg. § 1.707-5(a)(1).

38 Treas. Reg. § 1.707-5(a)(2)(i).

39 Treas. Reg. § 1.707-5(a)(2)(ii).

If, on the other hand, in a transaction that is not otherwise treated as part of a sale, a partnership assumes or takes subject to a qualified liability of the transferring partner,[40] the transfer will not treated as part of a sale.

The regulations describe four types of "qualified liabilities":

(i) A liability that was incurred by the partner more than two years before the earlier of the date the partner agrees in writing to transfer the property to the partnership or the date the partner transfers the property to the partnership, and that has encumbered the transferred property throughout that entire two-year period ("Two-Year Debt");[41]

(ii) A liability that was not incurred in anticipation of the transfer of property to the partnership, but that was incurred by the partner within the two-year period before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the property since it was incurred ("Nonanticipatory Debt");[42]

(iii) A liability that is allocable under the rules of Temp. Treas. Reg. § 1.163-8T to capital expenditures with respect to the contributed property ("Cap Ex Debt");[43] or

(iv) A liability incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if all of the assets related to that trade or business are transferred, other than

[40] Treas. Reg. § 1.707-5(a)(5)(i). As discussed below, it seems that assumptions of obligations that do not constitute liabilities also can give rise to a disguised sale of property under section 707(a)(2)(B). *See* T.D. 9207, 70 Fed. Reg. 30334 at 30339 (May 26, 2005) ("The intent of the proposed regulations under section 752 was not to override the disguised sale rules under section 707, which may include § 1.752-7 liabilities as consideration").

[41] Treas. Reg. § 1.707-5(a)(6)(i)(A).

[42] Treas. Reg. § 1.707-5(a)(6)(i)(B).

[43] Treas. Reg. § 1.707-5(a)(6)(i)(C). Temp. Treas. Reg. § 1.163-8T relates to the allocation of interest expense among various types of expenditures. The regulation provides that interest expense is allocated in the same manner as the debt to which the interest expense relates is allocated. Temp. Treas. Reg. § 1.163-8T(a)(3). It further provides that debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. *Id*. Generally, a liability is allocable to a capital expenditure to the extent that the proceeds of the liability are properly chargeable to capital account. Temp. Treas. Reg. § 1.163-8T(b)(3). Notice 89-35, 1989-1 C.B. 675, modified Temp. Treas. Reg. § 1.163-8T and provided that taxpayers may treat any expenditure made from any account of the taxpayer within 30 days before or 30 days after the debt proceeds are deposited into the account as made from the debt proceeds to the extent thereof. Notice 89-35 also expanded Notice 88-20, 1988-1 C.B. 487, and Notice 88-37, 1988-1 C.B. 522, which provided guidance on the allocation and reporting of interest expense in connection with (i) debt-financed contributions to the capital of, and purchases of interests in, passthrough entities and (ii) debt-financed distributions by passthrough entities to owners of those entities.

> assets that are not material to a continuation of the trade or business ("Ordinary Course Debt").[44]

The regulations do define the term "encumbered" for purposes of the definition of Two-Year Debt or Nonanticipatory Debt.[45]

If a partnership assumes or takes property or properties subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities assumed or taken subject to by the partnership pursuant to that plan immediately after the transfers equals the sum of that partner's shares of the liabilities (other than that partner's qualified liabilities) assumed or taken subject to by the partnership pursuant to the plan (the "§ 1.707-5(a) Liability Netting Rule").[46] Under this rule, each partner is permitted to offset that partner's nonqualified liabilities against other liabilities assumed or taken subject to by the partnership pursuant to a plan. The partners, however, are not permitted to offset their nonqualified liabilities against the partnership's pre-existing liabilities (*i.e.*, liabilities that are not assumed or taken subject to as part of a plan). The § 1.707-5(a) Liability Netting Rule does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as a transfer of consideration.[47]

4. Other Exceptions and Parallel Rules

The regulations contain a number of exceptions to sale treatment. For example, Treas. Reg. § 1.707-4(d) of the current regulations permits partners to be reimbursed for certain preformation expenditures:

> A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under [Treas. Reg.] § 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that –
>
> (1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

44 Treas. Reg. § 1.707-5(a)(6)(i)(D).

45 Commentators have suggested that, in the absence of guidance on this issue, the term "encumbered" should be interpreted broadly to include any right that places a creditor ahead of the debtor's general creditors with respect to a particular property or group of properties. *See, e.g.*, Gregory J. Marich & Barksdale Hortenstine, *A Comprehensive Guide to Interpreting and Living With the Rules Governing Disguised Sales of Property*, 110 Tax Notes 1421, 1463-64 (Mar. 27, 2006).

46 Treas. Reg. § 1.707-5(a)(4). The preamble to the final disguised sale regulations describes this rule as allowing the netting of nonqualified liabilities with qualified as well as nonqualified liabilities assumed or taken subject to in connection with an "integrated transaction." T.D. 8439, 57 Fed. Reg. 44974 (Sept. 30, 1992).

47 *Id*.

(2) Are incurred by the partner with respect to-

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.

In addition, the following types of distributions are presumed not to be proceeds from a disguised sale unless the facts and circumstances clearly establish that the distributions are part of a sale: (i) a reasonable guaranteed payment as defined in Treas. Reg. § 1.707-4(a)(3),[48] (ii) a reasonable preferred return as defined in Treas. Reg. § 1.707-4(a)(3),[49] and (iii) a member's proportionate share of the operating cash flow of the partnership as defined in Treas. Reg. § 1.707-4(b)(2).[50]

The disguised sale regulations generally provide that the rules described above apply with equal force, with certain modifications, to potential sales by partnerships to partners.[51]

C. IRS Guidance and Judicial Decisions

Both the IRS and the courts have addressed situations involved disguised sales and liability allocations, and it appears that portions of the Proposed Regulations are in response to these situations.

In *Canal Corp v. Commissioner*,[52] the Tax Court found that a distribution that otherwise would have qualified for the debt-financed exception did not qualify because an indemnity provided by the distributee-partner violated the anti-abuse rule of Treas. Reg. § 1.752-

48 Treas. Reg. § 1.707-4(a)(1).

49 Treas. Reg. § 1.707-4(a)(2).

50 Treas. Reg. § 1.707-4(b)(1).

51 Treas. Reg. § 1.707-6. For two recent cases applying the disguised sales rules to a distribution of property by a partnership, see *Gateway Hotel Partners, LLC v. Commissioner*, T.C. Memo 2014-5 (holding that the distribution of Missouri state historic tax credits to a partner of partnership did not constitute a sale of property); *Virginia Historic Tax Credit Fund 2001 LP et al. v. Commissioner*, 639 F.3d 129 (4th Cir. 2011) (holding that the allocation of Virginia state historic tax credits to partners of a partnership for U.S. federal income tax purposes constituted a sale of property).

52 *Canal Corp. v. Commissioner*, 135 T.C. 199 (Aug. 5, 2010).

2(j). Specifically, in *Canal*, Wisconsin Tissue Mills Inc. ("WISCO"), a subsidiary of Canal Corp. (formerly Chesapeake Corp.), formed a partnership with Georgia Pacific. WISCO received a 5 percent interest and $755 million in cash, which was funded by a loan from Bank of America to the partnership. Georgia Pacific received a 95 percent interest in the partnership. Georgia Pacific guaranteed the loan, and WISCO agreed to indemnify Georgia Pacific for any payments of principal it had to make under the guarantee. Chesapeake received a tax opinion from its tax advisor concluding that if WISCO maintained a net worth equal to or greater than 20 percent of its total liability under the indemnity, the partnership's liability would be allocated to WISCO, and WISCO would not recognize gain as a result of the cash distribution. The Tax Court found, among other things, that WISCO's net worth was substantially less than $755 million and that WISCO was under no contractual or legal obligation to retain any assets to support its indemnity obligations. The Tax Court disregarded WISCO's indemnity and concluded that none of the distribution to WISCO qualified for the debt-financed exception to disguised sale treatment.

Similarly, in ILM 201324013,[53] the IRS considered whether a taxpayer's indemnity should be disregarded. In concluding the indemnity should be disregarded under Treas. Reg. § 1.752-2(j), the IRS noted that the taxpayer (i) had no obligation to maintain any specific net worth or share its financial statements; (ii) did not receive a fee for providing the indemnity, (iii) provided no evidence the parties engaged in genuine negotiations regarding the indemnity, and (iv) did not record the indemnity as a liability or contingent liability on its financial statements. In addition, the IRS believed that there was no practical or commercial risk the obligation would be enforced. The taxpayer would not have to pay on its indemnity if the guarantors (which were affiliates of the other partner in the partnership) were unable to pay on their guarantees (or defaulted on their obligations under their guarantees). This was because the taxpayer's indemnity to the guarantors was only for payments actually made on their guarantees. The taxpayer had no obligation to the lender under its indemnity.

Finally, in TAM 200436011,[54] the IRS considered the allocation of excess nonrecourse liabilities. X was in the process of acquiring an interest in another company. To obtain cash for the acquisition, X decided to restructure and leverage its Z assets. X contributed its Z assets to Y, a limited liability company classified as a partnership for U.S. federal income tax purposes. Other parties contributed other assets. Y borrowed against its assets and distributed the loan proceeds to X. After the distribution, X owned all of the Senior Preferred Interest, and the other members owned all of the Junior Preferred and Junior Common Interests. The taxpayer took the position that Y's "excess nonrecourse liabilities" were properly allocable entirely to X under Tier 3 and that, for that reason, none of the distribution was properly treated as proceeds in a disguised sale. The IRS concluded that the preferred return was not a "significant item" within the meaning of the regulations, and, thus, Y could not allocate nonrecourse liabilities under Tier 3 solely to X.[55]

[53] June 14, 2013.

[54] April 30, 2004.

[55] *See also* CCA 200513022 (Apr. 1, 2005) (concluding that allocating debt in accordance with the preferred return at issue was not "intended by the third tier allocation permitted by § 1.752-3(a)(3)").

D. The Proposed Regulations

As noted above, the Proposed Regulations provide guidance regarding the allocation of partnership liabilities under section 752 and disguised sales under section 707. These two topics are discussed in the following two portions of this report.

1. Proposed Section 752 Regulations

The Proposed Regulations would dramatically modify a number of rules regarding the allocation of partnership liabilities, including (i) modifying the manner in which a partner's EROL is determined by requiring that a number of new requirements be satisfied, as well as requiring that a "net value" requirement be satisfied by most partners, for payment obligations to be given effect and (ii) eliminating two of the four methods currently permitted for allocating nonrecourse liabilities under Tier 3. These and other proposed changes are discussed below.

a. Recourse Liabilities

i. Payment Obligations

Under the current regulations, the determination of the extent to which a partner or related person has an obligation to make a payment that would cause the partner to bear the EROL for a particular partnership liability is based on the facts and circumstances at the time of the determination.[56] According to the preamble, the IRS and Treasury have considered

> whether the approach of the existing regulations under § 1.752-2 is appropriate given that, in most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The IRS and the Treasury Department are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner. The IRS and the Treasury Department believe that section 79 of the Tax Reform Act of 1984 (Pub. L. 98-369), which overruled the decision in *Raphan v. United States*, 3 Cl. Ct. 457 (1983) (holding that a guarantee by a general partner of an otherwise nonrecourse liability of the partnership did not require the partner to be treated as personally liable for that debt), and directed the Treasury Department to prescribe regulations under section 752 relating to the treatment of guarantees and other payment obligations, was intended to ensure that bona fide,

[56] Treas. Reg. § 1.752-2(b)(3).

commercial payment obligations would be given effect under section 752.[57]

Accordingly, the Proposed Regulations would provide that payment obligations of partners or related persons will not be recognized for purposes of section 752 unless each of the following seven requirements (together, the "Payment Obligation Requirements") is satisfied:

1. The partner or related person is—

   (a) Required to maintain a "commercially reasonable" net worth throughout the term of the payment obligation; or

   (b) Subject to "commercially reasonable" contractual restrictions on transfers of assets for inadequate consideration.

2. The partner or related person is required periodically to provide "commercially reasonable" documentation regarding the partner's or related person's financial condition.

3. The term of the payment obligation does not end before the term of the partnership liability.

4. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

5. The partner or related person received arm's length consideration for assuming the payment obligation.

6. In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of the partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. For this purpose, the terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would meet these Payment Obligation Requirements. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

7. In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any

[57] 79 Fed. Reg. 4830.

> amount of the indemnitee's or other benefitted party's payment obligation is satisfied.[58]

Each of these requirements is discussed below.

ii. The Net Value Rules

As a general matter, under current law, there is no requirement that a partner or related person have any particular net worth to support that partner's or related person's payment obligation for purposes of determining whether a partner bears EROL or has a payment obligation. Indeed, to the contrary, partners and related persons are presumed to satisfy their obligations without regard to their actual ability to do so.[59] This general presumption of ability to pay is subject to two significant exceptions. First, the regulations contain an anti-abuse rule that was applied by the Tax Court in *Canal Corp*. Second, Treas. Reg. § 1.752-2(k) provides that, in determining the extent to which a partner bears the EROL for a partnership liability, an obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity.[60]

Prop. Treas. Reg. § 1.752-3(b)(3)(iii)(B) would expand the Net Value Rules to payment obligations generally, other than to payment obligations of individuals and decedents' estates, as follows:

> In determining the extent to which a partner or related person other than an individual or a decedent's estate bears the economic risk of loss under [Treas. Reg. § 1.752-2(b)(1)] for a partnership liability other than a trade payable, a payment obligation is recognized only to the extent of the net value of the partner or related person as of the allocation date (as defined in [Treas. Reg. § 1.752-2(k)(2)(iv)]) that is allocated to the partnership liability. A partner or related person's net value is determined under the rules of paragraph (k) of this section. This paragraph (b)(3)(iii)(B) applies to a payment obligation of a partner or related person that is disregarded as an entity separate from its owner under sections 856(i) or 1361(b)(3) or §§ 301.7701-1 through 301.7701-3 of this chapter or is a trust to which subpart E, part I, subchapter J, chapter 1 of the Code applies (a disregarded entity), even if the owner of the disregarded entity is an individual or a decedent's estate. A partner or related person that is not a disregarded entity is treated as a disregarded entity for purposes of determining net value of the partner or related person under [Treas. Reg. § 1.752-2(k)].

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58 Prop. Treas. Reg. § 1.752-2(b)(3)(ii).

59 Treas. Reg. § 1.752-2(b)(6).

60 The disregarded entity's net value generally is determined when the liability is incurred and subsequently is adjusted on the occurrence of certain valuation events described in the regulations. Treas. Reg. § 1.752-2(k)(2)(ii).

Stated simply, the Net Value Rules would provide that the amount of partnership liabilities for which a partner may be treated as bearing the EROL cannot exceed the partner's net worth. If a partner's net worth changes, the limit in the Net Value Rules is similarly adjusted (but only at specified times). In addition, the Net Value Rules should not be confused with the first of the seven Payment Obligation Requirements (*i.e*., the obligation to maintain a commercially reasonably net worth or to be subject to limitations on one's ability to transfer assets without adequate consideration): whereas *all* payment obligations must satisfy the first Payment Obligation Requirement, individuals and decedents' estates do not need to satisfy the Net Value Rules.

iii. Rights to Reimbursement from Unrelated Third Parties

Under the current regulations, the amount of a partner's EROL is reduced by the amount the partner or a related person would be entitled to be reimbursed by *another partner* or person that is related to another partner.[61] The preamble states that "[t]he IRS and the Treasury Department have considered whether a right to be reimbursed for a payment or contribution by *an unrelated person* (for example, pursuant to an indemnification agreement from a third party) should be taken into account in the same manner and have concluded that *any source* of reimbursement that effectively eliminates the partner's payment risk should cause a payment obligation to be disregarded."[62] As a result, Prop. Treas. Reg. § 1.752-2(b)(1) would reduce the amount of a partner's EROL by the amount the partner is entitled to be reimbursed by any person, including an unrelated third party.

b. Nonrecourse Liabilities

The Proposed Regulations would modify Treas. Reg. § 1.752-3(a)(3) by removing the Significant Item Method and the Alternative Method, leaving excess nonrecourse liabilities to be allocated under the Remaining 704(c) Method and/or in accordance with the partners' interests in partnership profits.

Determining partners' interests in partnership profits in all but simple partnerships with "straight up" allocations is very challenging.[63] Recognizing the need for certainty, the Proposed Regulations would provide what appears to have been intended to be a safe harbor for determining the partners' shares of partnership profits. Under this approach, which the regulations refer as the "liquidation value percentage" approach, partners could share excess nonrecourse liabilities in accordance with their liquidation value percentages.[64] For this purpose, a partner's liquidation value percentage is the ratio (expressed as a percentage) of the

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[61] Treas. Reg. § 1.752-2(b)(1).

[62] 79 Fed. Reg. 4831 (emphasis added).

[63] *See* Sheldon Banoff, *Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, 85 Taxes 197 (Mar. 2007).

[64] Prop. Treas. Reg. § 1.752-3(a)(3). The liquidation value percentage approach appears to have its origins in a similar method proposed in an article advocating that the rules for allocating recourse liabilities be changed to reflect economic reality. *See* Eric Sloan and Jennifer Alexander, *Economic Risk of Loss: The Devil We Think We Know*, *supra* note 5 at 261-62.

"liquidation value" of the partner's interest in the partnership to the liquidation value of all of the partners' interests in the partnership. A partner's liquidation value, in turn, is the amount of cash the partner would receive with respect to the interest if, immediately after formation of the partnership or a revaluation event (as described in Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)),[65] the partnership sold – in a fully taxable transaction – all of its assets for cash equal to the fair market value of its property (taking section 7701(g) into account), satisfied all of its fixed liabilities and paid an unrelated third party to assume all of its contingent liabilities, and then liquidated.[66] A partner's liquidation value would be determined upon the occurrence of a revaluation event even if the partnership chooses not to revalue its assets under the section 704(b) regulations.[67]

c. Transition Rules

The Proposed Regulations under section 752 apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the effective date of the final regulations (the "Section 752 Effective Date"), other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect before that date.[68] There is a narrow transition rule for partners with a share of a recourse liability immediately before the Section 752 Effective Date.[69] The transition rule would apply for a period of seven years after the Section 752 Effective Date.[70]

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[65] The regulations under section 704(b) describe five different revaluation events: (i) in connection with a contribution of money or other property (other than a *de minimis* amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or (iii) in connection with the grant of an interest in the partnership (other than a *de minimis* interest), or (iv) in connection with the issuance by the partnership of a noncompensatory option (other than an option for a *de minimis* partnership interest), or (v) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. Treas. Reg. § 1.704-1(b)(2)(iv)(*f*)(*5*)).

[66] This type of "hypothetical sale" is used elsewhere in subchapter K. *See*, *e.g.*, Treas. Reg. §§ 1.743-1(d), 1.751-1(a)(2), and 1.755-1(b)(1)(ii).

[67] Prop. Treas. Reg. § 1.752-3(a)(3).

[68] Prop. Treas. Reg. § 1.752-2(l)(1).

[69] Prop. Treas. Reg. § 1.752-2(l)(2)(i) provides that if a partner has a share of a recourse partnership liability under § 1.752-2(b) immediately before the Section 752 Effective Date (a "Transition Partner"), the partnership (a "Transition Partnership") may choose not to apply § 1.752-2(b)(1) first sentence, § 1.752-2(b)(3), § 1.752-2(f), § 1.752-2 f) Examples 3, 10, 11, and 12, § 1.752-2(j)(4), § 1.752-2(k)(1) first sentence, and § 1.752-2(k)(2)(i)(A) to the extent the amount of the Transition Partner's share of liabilities under § 1.752-2(b) immediately before the Section 752 Effective Date exceeds the amount of the Transition Partner's adjusted basis in its partnership interest as determined under § 1.705-1 at that time (the "Grandfathered Amount"). The Transition Partnership may continue to apply the rules under § 1.752-2 in effect before the Section 752 Effective Date, with respect to a Transition Partner for liabilities described in § 1.752-2(b) to the extent of the Transition Partner's adjusted Grandfathered Amount for the seven-year period beginning the Section 752 Effective Date.

[70] Prop. Treas. Reg. § 1.752-2(l)(2)(i).

2. Proposed Disguised Sale Regulations

a. Qualified Liabilities

The Proposed Regulations would add a new type of qualified liability ("In Connection With Debt"), described as follows:

> A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a transfer presumed to be in anticipation of the transfer).[71]

As explained in the preamble to the Proposed Regulations (the "preamble"), "[t]he IRS and the Treasury Department believe the requirement that the liability encumber the transferred property is not necessary to carry out the purposes of section 707(a)(2)(B) when a liability was incurred in connection with the conduct of a trade or business, provided the liability was not incurred in anticipation of the transfer and all of the assets material to that trade or business are transferred to the partnership."[72] Thus, it seems that this new type of qualified liability – In Connection With Debt – is intended to permit nonanticipatory (or "old and cold") liabilities to be assumed or taken subject to by a partnership even if the liabilities do not encumber the transferred property and even if the liabilities would not constitute Ordinary Course Debt.[73] Although it would be helpful if final regulations were to provide some guidance

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[71] Prop. Treas. Reg. § 1.707-5(a)(6)(i)(E). The new type of ordinary course liability in Prop. Treas. Reg. § 1.707-5(a)(6)(i)(E) is subject to a notice requirement, but not adverse presumption, if incurred within 2 years. That is, the treatment of the liability as a qualified liability must be disclosed to the IRS in accordance with Treas. Reg. § 1.707-8, but there is no presumption that the liability was presumed in anticipation of the transfer. The rules relating to Treas. Reg. § 1.707-5(a)(6)(i)(D) ordinary course liabilities are unchanged as to both presumption and notice (*i.e.*, none, even if incurred within 2 years).

[72] Preamble to the Proposed Regulations, 79 Fed. Reg. 4826, 4828 (Jan. 30, 2014).

[73] The IRS has issued several letter rulings treating assets as subject to a partnership's liability if the creditor would have a claim against those assets in the event of default, and most practitioners likewise have concluded that a security interest is not required in order for debt to encumber property for this purpose. PLR 9815001 (Nov. 6, 1997); PLR 9815022 (Dec. 23, 1997); PLR 199903017 (Oct. 23, 1998); and PLR 199906025 (Nov. 17, 1998). Although the meaning of terms such as "encumber" or "subject to" are beyond the scope of this report, we strongly agree with the sensible and pragmatic approach taken by the IRS in these letter rulings. Although the new category of qualified liability would resolve this issue in the context of disguised sales, a similar issue remains very significant for purposes of Treas. Reg. § 1.704-2 (relating to nonrecourse deductions), Treas. Reg. § 1.752-3(b) (relating to the allocation of nonrecourse liabilities among assets that are "subject to" those liabilities), and the Remaining 704(c) Method. If a security interest were required for these rules, it would lead to illogical or nonsensical results, *e.g.*, that the liability cannot be allocated at all under Treas. Reg. § 1.752-3. Nevertheless, we understand that there may be less certainty regarding this issue within the government. By adding this new definition, the Proposed Regulations would, in effect, side step this issue.

regarding the meaning of the phrase "in connection with a trade or business," this new definition is a welcome addition to the regulations.[74] It would also be helpful if it were made clear that a liability may constitute In Connection With Debt even if the associated assets do not rise to the level of a trade or business.

b. Anticipated Reduction Rules

The current regulations contain an anticipated reduction rule that applies for purposes of determining a partner's share of a liability when a partnership assumes a liability from (or takes property subject to a liability of) a partner. That rule provides as follows:

> For purposes of this section, a partner's share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner's share if –
>
> (i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced; and
>
> (ii) The reduction of the partner's share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under § 1.707-3.[75]

The Proposed Regulations would add the following condition to the rule: "The anticipated reduction is not subject to the entrepreneurial risks of partnership operations."[76]

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74 The term "in connection with" generally has been construed, in other contexts, to mean having a *relation or connection* to the trade or business or other specified statutory activity. *See Snow v. Commissioner*, 416 U.S. 500 (1974) (experimental expenditures were deductible under section 174 as incurred "in connection with" the taxpayer's trade or business even though, at the time incurred, the activities did not constitute a trade or business for purposes of section 162); *Huntsman v. Commissioner*, 905 F.2d 1182 (8th Cir. 1990) (a debt incurred three years after the taxpayer purchased his residence was incurred "in connection with" the purchase of the residence as required by section 461(g)(2) when the debt replaced three-year balloon debt incurred at the time the residence was purchased); *Alves v. Commissioner*, 734 F.2d 478, 481-82 (9th Cir. 1984) (stock purchased by an employee was in connection with the performance of services under section 83 even though purchased at full market value and not considered compensation). As stated in TAM 200014007 (Dec. 13, 1999), "When Congress used 'in connection with' in section 108(c)(3)(A) it was aware of the Supreme Court's interpretation of this same language in *Snow*. Therefore, it is reasonable to assume that it intended the same broad interpretation be given to the language in the new type of qualified liability. *See also* Treas. Reg. § 1.108-2(d) (providing a safe harbor for purposes of determining whether a debt instrument issued by a partnership or S corporation is treated as having been issued in connection with the conduct of a trade or business).

75 Treas. Reg. § 1.707-5(a)(3). Although the meaning of the anticipated reduction rules is clear enough, their drafting is far from optimal. The rules focus on whether the *reduction* in the partner's share of the liability is part of a plan to minimize disguised sale treatment. Instead, the rules should focus on whether the initial – and arguably artificially high – allocation that is later reduced was part of a plan made with the purpose of minimizing the extent to which the transaction was treated as part of a disguised sale.

76 Prop. Treas. Reg. § 1.707-5(a)(3).

Under the Proposed Regulations, if a partner's share of a liability is reduced as the result of a reduction in the partner's (or related person's) net value, the reduction will be presumed to have been anticipated;[77] the presumption would be subject to rebuttal if the facts and circumstances clearly establish that the decrease in the net value was not anticipated.[78] Finally, the Proposed Regulations would similarly modify a comparable provision of the existing regulations applicable to debt-financed distributions.[79]

The preamble explains that the reason for the proposed modification was to address concerns among practitioners that the amortization of the principal amount of assumed liabilities (or liabilities that funded leveraged distributions) could be treated as a reduction within the meaning of this rule.[80] The rules, as modified, should reassure taxpayers that the amortization of debt funded by partnership earnings or assets will not run afoul of the anticipated reduction rules. If, though, cash were contributed to fund the debt amortization, it is possible that this would not satisfy the "entrepreneurial risks" requirement of the Proposed Regulations.

Because the proposed modifications to the anticipated reduction rule are balanced, *i.e.*, providing comfort without opening the door to abuse of the rule, we support them.

c. Preformation Capital Expenditures

In addition to re-designating subsections within Treas. Reg. § 1.707-4(d) for better organization, the Proposed Regulations would amend this rule in three ways.

First, the Proposed Regulations would provide that the limitation on the preformation capital expenditure exception applies "on a property-by-property basis."[81] Under the current regulations, there are varying interpretations of this rule. Although it is not clear that "property-by-property" is necessarily the best approach, we believe that clarity in the law is important and therefore support the proposed rule.[82]

Second, the Proposed Regulations would provide that for purposes of Treas. Reg. §§ 1.707-4(d) and 1.707-5, "the term capital expenditures has the same meaning as the term capital expenditures has under the Code and applicable regulations, except that it includes capital

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77 Prop. Treas. Reg. § 1.707-5(a)(3)(ii).

78 *Id.* Note that the Proposed Regulations also would require that any such reduction must be disclosed in accordance with Treas. Reg. § 1.707-8. *Id.*

79 Treas. Reg. § 1.707-5(b)(2)(iii); Prop. Treas. Reg. § 1.707-5(b)(2)(iii). The Proposed Regulations would also fix a drafting error in the existing regulations.

80 79 Fed. Reg. 4828-29 ("The IRS and the Treasury Department are aware that there is uncertainty as to when a reduction is anticipatory because it is generally anticipated that all liabilities will be repaid. Consistent with the overall approach of the existing regulations under section 707, the IRS and the Treasury Department believe that a reduction that is subject to the entrepreneurial risks of partnership operations is not an anticipated reduction, and the proposed regulations adopt this approach.")

81 Prop. Treas. Reg. § 1.707-4(d)(1)(ii)(B).

82 The Proposed Regulations do not provide any guidance regarding how to identify a single piece of property. *See*, *infra*, note 144.

expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures."[83] It should be noted that although the preamble describes this portion of the Proposed Regulation as a clarification, this portion of the Proposed Regulations is not effective until finalized. We support this proposed modification.[84]

Finally, as discussed more fully below, the Proposed Regulations would add a rule that would coordinate the reimbursement of preformation capital expenditures rule of Treas. Reg. § 1.707-4(d) with the Cap Ex Debt rule of Treas. Reg. § 1.707-5(a)(6). The new coordinating rule would provide that, for purposes of Treas. Reg. § 1.707-5(d)(1), if the capital expenditures were funded by Cap Ex Debt that is assumed or taken subject to by the partnership in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership to the partner exceeds the partner's share of the liability (as determined under Treas. Reg. § 1.707-5(a)(2)).[85]

d. Ordering Rule

Prop. Treas. Reg. § 1.707-5(b)(3) would add an ordering rule providing that the debt-financed distribution exception is applied before the exceptions in Treas. Reg. § 1.707-4. The ordering rule provides welcome clarity, and we support it.

e. Tiered Partnerships

The current regulations provide only a limited tiered partnership rule for cases in which a partnership succeeds to a liability of another partnership. Treas. Reg. § 1.707-5(e) provides:

> If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other

[83] Prop. Treas. Reg. § 1.707-4(d)(3). Although neither the Proposed Regulations nor the preamble provides any examples of these capitalization rules, presumably they include, but are not limited to, section 59(e) (providing an optional write-off period for certain qualified expenditures, including circulation expenditures, research and experimental expenditures, and intangible drilling costs), section 195 (allowing a deduction for certain start-up expenditures), section 263(c) (election to deduct intangible drilling and development costs), and section 709 (allowing a deduction for certain partnership organizational expenses).

[84] The preamble notes that "[t]he IRS and the Treasury Department considered whether a contributing partner's capital expenditures for this purpose should be reduced by the benefit of the tax deduction the contributing partner received prior to contribution of the property either because the capital expenditure was currently deductible by the contributing partner or recovered through amortization or depreciation deductions. The proposed regulations, however, do not adopt such an approach because the approach would be too burdensome to administer." 79 Fed. Reg. 4828. We agree with this decision.

[85] Prop. Treas. Reg. § 1.707-4(d)(2).

related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin.[86]

The Proposed Regulations would add two rules addressing tiered partnerships. First, Treas. Reg. § 1.707-5(b)(1) would be modified to clarify that the debt-financed distribution exception applies to tiered partnerships. To do this, Prop. Treas. Reg. § 1.707-5(b)(1) would provide that, for purposes of Treas. Reg. § 1.707-5(b), an upper-tier partnership's share of the liabilities of a lower-tier partnership that are treated as a liability of the upper-tier partnership under Treas. Reg. § 1.752-4(a) will be treated as liabilities of the upper-tier partnership incurred on the same day the liabilities were incurred by the lower-tier partnership. Second, Prop. Treas. Reg. § 1.707-5(e)(2) would provide rules to characterize liabilities attributable to a contributed (or distributed) partnership interest as qualified or nonqualified liabilities, generally by treating the liabilities associated with the transferred interest in the same manner as if the underlying assets had been transferred along with the underlying liabilities.

f. Assets-Over Partnership Mergers

Treas. Reg. § 1.752-1(f) provides for "netting" of increases and decreases in a partner's share of liabilities resulting from a single transaction. That regulation also specifically addresses assets-over partnership mergers, providing that "[w]hen two or more partnerships merge or consolidate under section 708(b)(2)(A), as described in § 1.708-1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under section 752."

Under Prop. Treas. Reg. § 1.707-5(f), when two or more partnerships merge or consolidate in an assets-over merger, "any increases or decreases in partnership liabilities associated with the merger or consolidation are netted by a partner in the terminating partnership and the resulting partnership for purposes of applying §§ 1.707-3 through 1.707-5 to transfers of money or other consideration by the terminating partnership to the partner."[87] The proposed rule appears to be responsive to practitioner comments that it was not clear that the liability netting rule under Treas. Reg. § 1.752-1(f) applies to the disguised sale rules.[88]

[86] Treas. Reg. § 1.707-5(e).

[87] We recommend that the netting rule also apply for purposes of applying Treas. Reg. § 1.707-6. Partnership mergers give rise to other ambiguities that trouble practitioners. For example, under Treas. Reg. § 1.704-4(c)(4), section 704(c)(1)(B) does not apply to an assets-over partnership merger. *See* Treas. Reg. § 1.737-2(c) for a similar rule in the context of section 737. It is not clear whether this exception applies to mergers governed by the partner buyout rule of Treas. Reg. § 1.708-1(c)(4). It would be helpful if the regulations were modified to make clear that sections 704(c)(1)(B) and 737 are not implicated in partnership mergers other than mergers involving actual distributions of partnership assets. Such a clarification would make the exception for partnership mergers consistent with the exception for partnership incorporations.

[88] *See*, *e.g.*, Monte A. Jackel and Suzanne Walsh, *Disguised Sales Revisited*, 114 Tax Notes 179 (Jan. 17, 2007).

g. Contingent Liabilities

The current language of Treas. Reg. § 1.707-5(a)(2) defines the term "liability" for purposes of the disguised sale rules as follows:

> (i) A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1) **or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section**.
>
> (ii) A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability of the partnership under § 1.752-1(a)(2) **or would be a nonrecourse liability of the partnership under § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section**.

(Emphasis added.) The Proposed Regulations would delete the bolded portion of the existing definition. The preamble does not explain the reason for the proposed deletion.

h. Effective Date

The Proposed Regulations regarding disguised sales apply to any transaction with respect to which *all* transfers occur on or after the effective date of the final regulations.

III. Detailed Discussion – Proposed Regulations under Section 752

A. Comments on the Basic Approach of the Proposed Regulations

The existing regulations under section 752, which were issued in temporary form in 1989 and finalized in 1991, reflects the Congressional repudiation of the decision of the United States Claims Court in *Raphan*. The Proposed Regulations reflect the first major departure from the analytical framework of the existing regulations.[89] According to the preamble, the government has determined that the Congressional directive to over-rule *Raphan* does not require that all guarantees be given effect for purposes of allocating debt, but rather requires only that "bona fide, commercial payment obligations" affect the allocation of partnership liabilities.[90] We believe that the government's overall stated objective is justified insofar as the government seeks to give effect only to "bona fide, commercial payment obligations."[91] To that extent, we support the overall objective of the Proposed Regulations.[92]

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[89] The regulations were amended in 2000 to add the Remaining 704(c) Method. T.D. 8906, 65 Fed. Reg. 64888 (Oct. 31, 2000). The regulations were amended again in 2006 to address partners that hold their interests through disregarded entities. T.D. 9289, 71 Fed. Reg. 59669 (Oct. 11, 2006).

[90] 79 Fed. Reg. 4830.

[91] In this respect, the Proposed Regulations relating to section 752 in a sense seek to determine whether a payment obligation is sufficiently "real" to be recognized for purposes of section 752. Yet, as is discussed below,

We have serious misgivings, however, about some of the specific proposals contained in the Proposed Regulations (and the apparent consequences of those proposals) and therefore recommend a number of substantial changes to those proposals.

It seems clear that the effect (and perhaps the intention) of the Proposed Regulations would be to make it much more likely that liabilities will be treated as nonrecourse under section 752, allocable under the rules of Treas. Reg. § 1.752-3. On the one hand, this seems appropriate as an economic matter because, in our experience, lenders, borrowers, and credit support providers generally expect borrowers to satisfy their obligations. On the other hand are three concerns. First, as is discussed below, this represents a dramatic change in the manner in which partnership liabilities would be allocated under section 752, which is perhaps surprising in light of the fact that much of the impetus for the Proposed Regulations arises from concerns about the disguised sale rules. Second, the treatment of a liability as nonrecourse under section 752 requires (or should require) that the deductions generated by that liability be allocated under the special rules applicable to nonrecourse liabilities found in Treas. Reg. § 1.704-2, which may make it easier for taxpayers to engage in aggressive or abusive transactions.[93] Although this result seems to be a necessary and natural consequence of the Proposed Regulations, and notwithstanding that lawyers in the IRS and Treasury have indicated

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under the Proposed Regulations, a payment obligation would not be recognized unless it satisfied all of the requirements of the Proposed Regulations *even if* the payment obligation were legally binding and would in fact be called upon if the assets of the partnership proved to be insufficient to satisfy the underlying liability. For example, even if the payment obligation is "real," but its terms do not reflect what might have been required by a third-party guarantor (*e.g.*, no guarantee fee is paid), the Proposed Regulations would not recognize the payment obligation. Conversely, it appears that, under the Proposed Regulations, if the obligation is "real" and reflects arm's length terms, the payment obligation would be recognized even if other factors indicate that the primary purpose for the creation of the payment obligation was to avoid recognizing gain under section 707 or section 731(a) and that it is unlikely that the obligation will in fact be called upon and satisfied (because, for example, the partnership is well capitalized).

92 The validity of tax regulations is governed by the two-part test announced in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The first part asks whether Congress has directly addressed the precise question at issue. The second part asks whether the rule is a reasonable interpretation of the enacted text. *Mayo Foundation for Medical Educ. and Research v. United States*, 131 S.Ct. 704 (2011).

93 For example, consider a situation in which three unrelated publicly traded corporations, X, Y, and Z form LLC, with X contributing $20, and Y and Z each contributing $40 for 20 percent, 40 percent, and 40 percent interests, respectively. LLC borrows $300 from a third-party and buys a depreciable asset from an X affiliate for $400. X guarantees repayment of the borrowing in a manner that would be recognized under current law, but in a manner that would not be recognized under the Proposed Regulations. The asset is leased to an affiliate of X.

Under both current law and the Proposed Regulations, the first $100 of depreciation deductions from the asset would be allocated to the members in proportion to their interests. Under current law, the remaining $300 of depreciation deductions would be allocated entirely to X. Under the Proposed Regulations, however, the remaining $300 of depreciation would be allocated to the members in proportion to their interests. (Example 6, *infra*, addresses the same allocation issue in the context of deficit restoration obligations.)

Such a transaction structure, which would be quite easy to implement under the Proposed Regulations, is eerily reminiscent of old-style tax shelters. It should be noted that the substantial economic effect regulations of section 704(b), the passive activity loss rules of section 469, and the at-risk rules of section 465 are weapons in the arsenal that Congress, the IRS, and Treasury built as part of their successful battle against the tax shelters of the 1970s and early 1980s.

that they appreciate the potential impact of the Proposed Regulations on the allocation rules of section 704(b), there is no indication in the text of or preamble to the Proposed Regulations that this potential impact was in fact intended. Perhaps for this reason, a substantial portion of the tax bar appears to have only recently come to understand this potential change to the manner in which debt-funded deductions would be allocated among partners. Third, although there are flaws in the existing regulations, the proper allocation of partnership liabilities among the partners generally is reasonably clear under the existing regulations; it seems that the Proposed Regulations would introduce substantial subjectivity – and, therefore, uncertainty – into the allocation of partnership liabilities.

Principally for these reasons,[94] we recommend that the IRS and Treasury consider taking a more narrowly tailored approach that focuses on the disguised sale rules and that treats – solely for disguised sale purposes – all partnership liabilities as nonrecourse liabilities.[95] We believe that such an approach would be consistent with Congressional intent, would address the vast majority of situations that motivated the issuance of the Proposed Regulations, would reflect the economic reality that most partnership liabilities are satisfied (and are expected to be

[94] Note that modifications to the liability allocation rules under section 752 may have tax consequences outside of subchapter K, whereas modifications to the disguised sales rules would not. For example, an individual partner's at-risk amount for purposes of section 465 generally includes the partner's share of recourse debt, but does not include the partner's share of nonrecourse debt. *See*, *e.g.*, AM 2014-003 (Aug. 27, 2013) (when a member of an LLC classified as a partnership or disregarded entity guarantees the LLC's debt, the member is at risk with respect to the amount of the guaranteed debt, without regard to whether such member waives any right to subrogation, reimbursement, or indemnification from the LLC, but only to the extent that the member has no right of contribution or reimbursement from persons other than the LLC, the member is not otherwise protected against loss within the meaning of section 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law). The extent to which the Payment Obligation Requirements are intended to apply for purposes of determining a partner's at-risk amount under section 465 is not clear. It would be helpful if the final regulations provide guidance on this issue. Note that if, in the final regulations, there are any subjective aspects to the criteria for determining whether a payment obligation is respected (such as whether a fee is arms' length), different partners in the same partnership may take different positions regarding how those requirements apply to a particular set of facts, with each partner taking the position that causes that partner to have a larger share of the partnership's liability, as seems to have been the case in AM 2014-003.

[95] Although we doubt that this approach could be adopted for purposes of section 752 in light of the 1984 legislative history to the *Raphan* override, the legislative history underlying the disguised sale rules does not seem to require that the disguised sale rules be tied to the section 752 regulations. Indeed, Congress added section 707(a)(2)(B) to the Code as part of the Tax Reform Act of 1984 in response to cases such as *Otey v. Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980), that Congress believed should be treated as disguised sales. Deficit Reduction Act of 1984, Division A, Tax Reform Act of 1984, Pub. L. No. 98-369, § 73, 98 Stat. 494, 591, as amended by the Tax Reform Act of 1986, Pub. L. 99-514, § 1805(b), 100 Stat. 2810. In *Otey v. Commissioner*, the taxpayer contributed real property to a partnership and received the proceeds of a partnership borrowing. The Tax Court found that the transaction was not a sale, based in part on the fact that the taxpayer remained liable for the borrowing. Although the legislative history under section 707(a)(2)(B) specifically mentions *Otey* as an example of a case to which Congress believed section 707(a)(2)(B) would apply, *see* S. REP. NO. 98-169, at 225 (1984); H.R. REP. NO. 98-432, at 1218 (1984), if *Otey* were litigated under Treas. Reg. § 1.707-5, the transaction would not constitute a disguised sale because Treas. Reg. § 1.707-5 specifically incorporates the economic risk of loss rules of the regulations under section 752. It is not clear whether the IRS and Treasury appreciated this when issuing Treas. Reg. § 1.707-5. It seems to us that the IRS and Treasury could promulgate regulations that would have the result of overturning the result in *Otey*, as they were authorized (and perhaps directed) to do in 1984.

satisfied) by the partnership, and would be far less disruptive to the existing regulatory framework in subchapter K that has been carefully developed over the last 58 years, particularly over the last 30 years.

Specifically, we recommend that the IRS and Treasury consider providing in the final regulations that, solely for disguised sale purposes, a partner's allocable share of a partnership liability (including a liability assumed or taken subject to by the partnership in connection with the contribution of property by the partner to the partnership) equals the portion of the liability that would be allocated to the partner if the entire liability were allocable among the partners under the provisions of Treas. Reg. § 1.752-3(a)(3) (but excluding for this purpose the Significant Item Method and the Alternative Method); *provided*, *however*, that the partner's allocable share of any such liability should not include any portion of the liability with respect to which another partner bears the economic risk of loss.

We recognize, however, that bottom-dollar guarantees and limited net worth credit support providers have attracted the attention of the government. Therefore, even if the approach described above were adopted, we would support the inclusion in the final regulations of (i) the provisions limiting bottom-dollar guarantees in Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) and (G), as modified by our recommendation discussed below; and (ii) the provisions expanding the application of the Net Value Rules, also as modified by our recommendation discussed below. Our support for the inclusion of these provisions is tempered in two respects. First, if, as we believe, it is determined that the inclusion of these provisions would result in substantial changes to the manner in which partnership deductions are allocated under section 704(b) (applying well-understood section 704(b) principles), we recommend that the IRS and Treasury consider seeking additional public comments before finalizing those provisions. (We discuss this issue in Part III.C, below.) Second, we believe that the expansion of the Net Value Rules is likely to lead to substantial difficulties for both taxpayers and the IRS. For this reason, we believe the IRS and Treasury should consider whether it would be preferable to expand the anti-abuse rule currently found in Treas. Reg. § 1.752-2(j) rather than to expand the Net Value Rules. This could be done by enhancing the text of Treas. Reg. § 1.752-2(j) and including examples that would directly address transactions like the ones in *Canal* and ILM 201324013.

If, however, our recommended approach is <u>not</u> adopted, we have two over-arching alternative recommendations. First, we recommend that, solely for disguised sale purposes (and not for purposes of allocating liabilities among partners under section 752), the final regulations should: (i) prevent bottom-dollar guarantees by adopting the requirements in Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) and (G); (ii) impose minimum net worth requirements on all partners and related persons, including individuals and decedents' estates; and (iii) prohibit the use of the Significant Item Method and the Alternative Method. Second, for purposes of allocating liabilities among partners under section 752, the Proposed Regulations should be finalized taking into account our recommendations discussed below.

B. Payment Obligations

To reiterate, if our recommendation above were adopted, we recommend that the only provisions of the Proposed Regulations relating to recourse liabilities under section 752 that should be finalized are (i) the provisions limiting bottom-dollar guarantees in Prop. Treas. Reg.

§ 1.752-2(b)(3)(ii)(F) and (G), as modified by our recommendation discussed below; and (ii) the provisions expanding the application of the Net Value Rules, also as modified by our recommendation discussed below.

1. Overview

As noted above, the Proposed Regulations would provide that payment obligations of partners or related persons will not be recognized for purposes of section 752 unless all of the following requirements (*i.e.*, the Payment Obligation Requirements) are satisfied:

1. The partner or related person is—

   (a) Required to maintain a "commercially reasonable" net worth throughout the term of the payment obligation; or

   (b) Subject to "commercially reasonable" contractual restrictions on transfers of assets for inadequate consideration.

2. The partner or related person is required periodically to provide "commercially reasonable" documentation regarding the partner's or related person's financial condition.

3. The term of the payment obligation does not end prior to the term of the partnership liability.

4. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

5. The partner or related person received arm's length consideration for assuming the payment obligation.

6. In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of the partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. For this purpose, the terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would meet these Payment Obligation Requirements. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

7. In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any

amount of the indemnitee's or other benefitted party's payment obligation is satisfied.[96]

Before discussing each specific requirement, we note that the various Payment Obligation Requirements appear to be based on the government's belief about what a third party lender receiving credit support would require of a credit support provider, and what a credit support provider would seek from the obligor. Although most of the Payment Obligation Requirements generally strike us as reasonable, for three reasons we do not support mandating that each requirement be satisfied. First, in our experience, commercial arrangements among third parties rarely, if ever, satisfy every single Payment Obligation Requirement. Second, commercial practices tend to change over time, which could quickly render the Payment Obligation Requirements out of date. Third, the proposed Payment Obligation Requirements would make it fairly easy for a partner to provide meaningful credit support for partnership liabilities while permitting the liabilities to be treated as nonrecourse under section 752. This may be intended by the drafters of the Proposed Regulations, but it will place a premium on tax planning.

The Proposed Regulations specifically provide that the terms of a guarantee or similar arrangement will be treated as modified by any rights of indemnity or similar arrangement "regardless of whether that arrangement" satisfies all of the Payment Obligation Requirements.[97] This provision effectively forecloses the possibility of intentionally failing one or more of the Payment Obligation Requirements as a means of allocating partnership liabilities to the "wrong" person. For example, assume that X contributes appreciated property to LLC in exchange for an LLC interest and a debt-financed distribution. X guarantees repayment of LLC's borrowing, and Y, another LLC member, indemnifies X, so that if X actually makes any payments under the guarantee, Y will reimburse X. With the sole purpose of ensuring that the distribution does not result in the recognition of gain by X, X ensures that its guarantee satisfies all of the Payment Obligation Requirements, and Y's indemnity intentionally fails one (*e.g.*, X does not pay Y for providing the indemnity). Y's indemnity protects X from any economic exposure with respect to LLC's borrowing, but X is treated as having the EROL for the liability. This would be inappropriate, and the Proposed Regulations appear to anticipate this type of planning and make clear that it would not be effective. We recommend that the regulations, when finalized, ensure that this type of planning would not be effective.

We also note that it appears that if the facts of the *Raphan* case were tested under the Proposed Regulations, the guarantor's payment obligation would not have been respected, with the result that the limited partners would have been allocated the debt under section 752.[98] This result would be in considerable tension with Congress's specific direction that the section 752 regulations overturn the holding in *Raphan*.[99] Therefore, we recommend that the final

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96 Prop. Treas. Reg. § 1.752-2(b)(3)(ii).

97 Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(F) (second sentence).

98 *See Raphan*, 759 F.2d at 885 (noting that the general partners "did not act at arm's length in guaranteeing the construction loan. They did not charge [the partnership] for the guarantee, as would an unrelated person").

99 Situations have occurred in the past in which regulations would not have applied to cases disapproved of by Congress when amending the Code. For example, as observed *supra* note 95, even though Congress intended for

regulations provide that only payment obligations that contain terms that are reasonably consistent with customary commercial practices for similar arrangements among unrelated third parties will be given effect under the section 752 regulations.[100] For this purpose, the final regulations should contain a nonexclusive list of facts and circumstances that would be relevant in determining whether this requirement was satisfied and should provide that no single factor is determinative;[101] we would expect this list to contain many of the proposed Payment Obligation Requirements. In addition, we recommend that the preamble to the final regulations specifically explain why the final regulations are consistent with Congress's directive to over-rule *Raphan*. In that regard, we note the guarantee at issue in *Raphan* is distinguishable from the types of non-commercial guarantees that would not be recognized under the Proposed Regulations, as modified by our recommendation in this paragraph, because, in *Raphan*, it appears that the guarantee was put in place for commercial, not tax, reasons.

2. Discussion of Each Payment Obligation Requirement

In this section, we discuss our recommendations regarding each of the proposed Payment Obligation Requirements.

a. "Commercially Reasonable" Net Worth and Restrictions on Transfer

Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A) would require the partner or related person (i) to maintain a commercially reasonable net worth throughout the term of the payment obligation; or (ii) to be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration. The Proposed Regulations do not provide any guidance regarding the consequences of a credit provider's breach of its contractual obligations. That is, the Proposed Regulations require only that the partner or related person be required to maintain a commercially reasonable net worth or (ii) be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration. What happens if the loan agreement satisfies this requirement but the partner or related person simply breaches its obligations under the loan agreement? It appears that such a breach would not cause the payment obligation to be disregarded under the Proposed Regulations. This result is not particularly troubling (if intended), unless the facts and circumstances demonstrate that the

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the regulations under section 707(a)(2)(B) to over-turn the result in *Otey*, if *Otey* were litigated under Treas. Reg. § 1.707-5, the transaction would not constitute a disguised sale.

[100] Other Treasury regulations look to whether certain activities are consistent with market practices. For example, although income from services generally is not qualifying income for a real estate investment trust (a "REIT") under section 856(c), REITs may earn income from providing services that are "customarily furnished or rendered in connection with the rental of real property." Treas. Reg. § 1.856-4(b)(1); Prop. Treas. Reg. § 1.856-4(b)(3). *See also* Treas. Reg. § 1.512(b)-1(c)(5) (similar rule for determining the unrelated business taxable income of certain tax-exempt organizations).

[101] This "facts and circumstances" approach is used elsewhere in the Treasury regulations. *See, e.g.*, Treas. Reg. § 1.707-3(b)(2) (listing "the facts and circumstances that may tend to prove the existence of a sale" under the disguised sale regulations); Treas. Reg. § 1.355-7(b) (listing the "facts and circumstances to be considered in demonstrating whether a distribution and an acquisition are part of a plan" that would cause the distribution to be taxable to the distributing corporation under section 355(e)).

lender never intended to enforce its rights, rendering the obligations of the partner or related person meaningless, in which case the obligations should be disregarded. It may be advisable for the final regulations to include a specific anti-abuse rule addressing these situations.

It should be noted that these requirements are of greater importance to individuals and decedents' estates, as all other persons would be subject to the minimum net worth rules of Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B). Nevertheless, we recommend that the final regulations provide guidance on these issues.

b. "Commercially Reasonable" Documentation

Similar questions are raised by the requirement regarding documentation. Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(B) would require the partner or related person periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition. The same issue raised by the first of the Payment Obligation Requirements regarding breach is raised by the documentation requirement. In addition, the final regulations should make clear that the documentation must be provided to the lender, not the partnership.

c. Term of the Payment Obligation

Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(C) would require the term of the payment obligation not to end before the term of the partnership liability. The preamble does not explain the rationale for this requirement, but we assume that it was intended to ensure that the payment obligation is not transitory. In this regard, we note that, in our experience, it is not uncommon for lenders to require credit support for only a limited period of time, such as until a project is "leased up," or certain income and/or asset coverage ratios are satisfied for a specified number of quarters, or the debt is rated "investment grade." For this reason, we are not supportive of this Payment Obligation Requirement.

If the IRS and Treasury are concerned about transitory arrangements, perhaps a rebuttable two-year presumption like that of the existing regulations would be appropriate.[102] Thus, for example, if the credit support exists for at least two years, it would presumptively be respected (or taken into account in a facts and circumstances analysis if our initial recommendation that the multi-factor test of the Proposed Regulations be modified).

If our recommendation is not accepted, it would be helpful for the final regulations to provide guidance regarding how to determine for this purpose the term of a loan that can be extended or shortened via renewal options or early termination options at the option of the lender, the borrower, or both.[103]

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[102] *See* Treas. Reg. § 1.707-3(c) (transfers within two years presumed to be parts of a disguised sale), -3(d) (transfers more than two years apart presumed not to be parts of a disguised sale).

[103] *See*, *e.g.*, Treas. Reg. § 1.1272-1(c) (rules for determining the maturity date of a debt instrument with contingencies for purposes of calculating original issue discount).

d. No Requirement to Hold Excessive Money or Liquid Assets

Under the fourth Payment Obligation Requirement, neither the primary obligor nor any other obligor with respect to the partnership liability may be required to hold, directly or indirectly, money or other liquid assets in an amount that exceeds the reasonable needs of the obligor.[104] This requirement seems to be directed at transactions like those described in ILM 201324013, in which the IRS asserted that the taxpayer "intended, and acted, to ensure that the Partnership maintained sufficient collateral . . . to repay the Bank without exposing [the indemnitor] to meaningful liability on the indemnity."[105] The legal theory unpinning this requirement, as explained by the ILM, is not troubling as a policy matter. It would be helpful, however, for the final regulations to specifically acknowledge that commercially required or prudent "keep-wells" and other reserves satisfy the "reasonable needs" requirement even if the funds are not necessarily material to the continuation of the obligor's trade or business.[106]

e. Arm's Length Consideration

Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(E) would require the partner or related person to receive arm's length consideration for assuming a payment obligation. In our experience, it is standard commercial practice for an owner to guarantee entity-level obligations without receiving a fee for doing so. The observation that there is a transfer of value involved in a guarantee[107] is not, in our view, enough to require fees to be paid when they are not typically paid. For this reason, we recommend that this Payment Obligation Requirement not be included in the final regulations. In addition, we recommend that the final regulations make clear that the failure of a credit support provider to be paid for providing the credit support is not a factor to be taken into account in determining whether the credit support is a *bona fide* commercial arrangement that will be recognized under the final regulations.

f. Bottom Dollar Guarantees

The next Payment Obligation Requirement is directed toward so-called "bottom dollar guarantees" in which the guarantor (or other credit support provider) is at risk for

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104 Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(D).

105 This requirement is reminiscent of one of the facts and circumstances to be taken into account in determining whether two transfers constitute a disguised sale. Treas. Reg. § 1.707-3(b)(2)(vii) ("the partnership holds money or other liquid assets, beyond the reasonable needs of the business").

106 *Cf*. Treas. Reg. § 1.707-5(a)(6)(i)(D) (a liability is a qualified liability if it was incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if all of the assets related to that trade or business are transferred, other than assets that are not material to a continuation of the trade or business).

107 Clifford Warren, special counsel to the IRS associate chief counsel (passthroughs and special industries), stated at a Practising Law Institute conference: "No one can really argue the fact that there is a transfer of value on a guarantee, and whether it's worth $1 or $1 million or tens of million[s] of dollars is" the ultimate question. Amy S. Elliott, *Tranched Debt May Be Respected Under New Bottom-Dollar Guarantee Rules*, 143 Tax Notes 35 (Apr. 7, 2014).

repayment for only the most secure portion of a liability. To address these types of guarantees, Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) would require:

> In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. For purposes of this paragraph (b)(3)(ii)(F), the terms of a guarantee or similar arrangement will be treated as modified by any right of indemnity, reimbursement, or similar arrangement regardless of whether that arrangement would be recognized under [§ 1.752-2(b)(3)]. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

The Proposed Regulations include the following example to illustrate the proposed rule regarding guarantees.[108]

> Example (10). Guarantee of first and last dollars. (i) A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other. A's and B's guarantees satisfy the requirements set forth in paragraphs (b)(3)(ii)(A) through (E) and paragraph (b)(3)(iii) of this section.
>
> (ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee satisfies the requirement under paragraph (b)(3)(ii)(F) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under paragraph (a)(1) of this section is $300. However, because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee does not satisfy the requirement under paragraph (b)(3)(ii)(F) of this section and B's payment obligation is not recognized. Therefore, B bears no economic risk of loss under paragraph (a)(1) of this section for ABC's liability. As a result, $300 of the liability is allocated to A

108 Prop. Treas. Reg. § 1.752-2(f), *Example 10*.

> under paragraph (a)(1) of this section and the remaining $700 liability is allocated to A, B, and C under § 1.752-3.

Although we are sympathetic to the concerns apparently motivating this proposed Payment Obligation Requirement, we have five comments.

First, the language of Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F), which in effect attempts to define a bottom-dollar guarantee, is confusing. It would be helpful for the final regulations to have additional examples of bottom-dollar and top-dollar guarantees.

Second, we are troubled by the fact that the requirement would permit substantially similar arrangements to be treated very differently for tax purposes, which would place a premium on form and careful tax planning. Consider the following examples:

> **Example 2**. X and Y form LLC, each contributing $1 million. LLC borrows $8 million from an unrelated Bank One and acquires an asset for $10 million. X guarantees repayment of the "bottom" $1 million of the loan, *i.e.*, X will have to pay on the guarantee only to the extent that the bank collects less than $1 million. No other credit support is provided.

> **Example 3**. The facts are the same as in Example 2, except that LLC borrows $1 million from Bank One and $7 million from Bank Two. The loan from Bank Two is subordinated to the loan from Bank One. X guarantees repayment of the entire $1 million loan from Bank One. No other credit support is provided.

X, in its position as the guarantor, is in economically identical positions in Example 2 and Example 3, but, under the Proposed Regulations, the guarantee in Example 2 would not be respected, whereas it appears the guarantee in Example 3 would be respected.[109] In this regard, the preamble notes that the IRS and Treasury are concerned that "a financial intermediary might artificially convert a single mortgage loan into senior and junior tranches using a wrap-around mortgage or other device with a principal purpose of creating tranches for partners to guarantee that result in exposure tantamount to a bottom-dollar guarantee"[110] and therefore requests comments on whether other structures or arrangements might be used to circumvent the rules regarding bottom-dollar guarantees and whether the final regulations should broaden the anti-abuse rule further to address any such structures or arrangements.

We agree that "tranches" of debt could be used to effect arrangements that are economically similar to bottom-dollar guarantees and recommend that the final regulations contain an anti-abuse rule to address tranched debt and similar arrangements. Specifically, in

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109 Clifford Warren, special counsel to the IRS associate chief counsel (passthroughs and special industries), stated at a Practising Law Institute conference: "If it's a true tiered loan and there really is a first and second – it was not artificially contrived through some intermediary – I think we would respect that." Amy S. Elliott, *Tranched Debt May Be Respected Under New Bottom-Dollar Guarantee Rules*, 143 Tax Notes 35 (Apr. 7, 2014).

110 79 Fed. Reg. 4830.

applying Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F), we recommend that two or more liabilities be treated as a single liability if (i) the liabilities are incurred pursuant to a common plan, as part of a single transaction, or as part of a series of related transactions, (ii) the liabilities have the same counter-party or counter-parties (or substantially the same group of counter-parties), (iii) the guarantee or similar arrangement being tested would fail to satisfy the requirements of Prop. Treas. Reg. § 1.752-3(b)(3)(ii)(F) if the liabilities were treated as a single liability, and (iv) multiple liabilities (rather than a single liability) were incurred with a principal purpose of avoiding Prop. Treas. Reg. § 1.752-3(b)(3)(ii)(F). For this purpose, (i) the term "counter-parties" refers to the ultimate counter-parties, (ii) an intermediary, such as a bond house, broker, or similar person or organization acting in the capacity of an underwriter, placement agent, or wholesaler, would be disregarded, and (iii) related[111] counter-parties would be treated as one counter-party.[112]

Third, the IRS and Treasury also specifically requested comments on whether, and under what circumstances, the final regulations should permit recognition of a payment obligation for a portion, rather than 100 percent, of each dollar of a partnership liability to which the payment obligation relates (a so-called "vertical slice" of a partnership liability). The Proposed Regulations would not recognize this type of guarantee, as demonstrated by the following example:[113]

> **Example 4**. Partial guarantee of partnership liability. (i) A, B, and C are equal members of limited liability company, ABC, that is classified as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of 25 percent of each dollar of the $1,000 liability that is not recovered by Bank. A's guarantee satisfies the requirements set forth in Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A) through (E) and (b)(3)(iii).
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> (ii) If $250 of the $1,000 partnership liability is not recovered by Bank, A is only obligated to pay $62.50 ($250 x 0.25) pursuant to the terms of the guarantee. Because A is not obligated to pay up to the full amount of its payment obligation ($250) to the extent that $250 is not recovered by Bank, A's guarantee does not satisfy the requirement under Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F), and A's payment obligation is not recognized. As a result, the ABC liability is allocated to A, B, and C under Treas. Reg. § 1.752-3.

The guarantor under such a guarantee is in a first loss position, which seems to be the objective of the Payment Obligation Requirement. Therefore, recognizing such a guarantee is not inconsistent with the intention of the Proposed Regulation. In addition, permitting vertical slice guarantees would permit economically similar arrangements to be treated similarly. That is,

[111] For this purpose, persons would be treated as related if they are described in section 267(b) or 707(b).

[112] Portions of this proposed rule are drawn from Treas. Reg. § 1.1275-1(f)(1) (treating multiple debt issuances as a "single issue" for purposes of sections 163(e) and 1271 through 1275).

[113] This example is based on Prop. Treas. Reg. § 1.752-2(f), *Example 12*.

although a guarantor's right of reimbursement from another party generally would be taken into account in determining whether the guarantee is a prohibited bottom-dollar guarantee, this reduction would not apply "to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable."[114] If, as is generally required by the existing regulations, one assumes that all parties will satisfy their obligations, the final sentence of this requirement comes very close to permitting vertical slices, as demonstrated by the following example:

> **Example 5**. X, Y, and Z are members of LLC, which borrows \$100 from Bank. X and Y both guarantee full repayment of the borrowing and agree, as between themselves, that each will bear half of the liability. Based on the regulatory presumption that the parties will satisfy their obligations, X and Y are each at risk for \$50. Under the Proposed Regulations, X's and Y's payment obligations would be recognized, and each would be allocated \$50 of the liability under section 752.
>
> If, on the other hand, X and Y had each guaranteed 50 percent of each dollar of the \$100 liability, neither payment obligation would be recognized. As a result, the liability would be a nonrecourse liability and would be allocated among X, Y, and Z under Treas. Reg. § 1.752-3.

The two arrangements between X and Y are, fundamentally, economically very similar, if not identical, and should, we believe, be treated similarly for tax purposes. For this reason, we disagree with the results reached by the example in the Proposed Regulations and recommend that "vertical slice" guarantees be recognized under the final regulations.[115]

Fourth, although we appreciate the merits of the bright-line rule of the Proposed Regulations that would require a credit support provider to be at risk for each dollar of a liability, we recommend that the final regulations adopt a modified rule that would adopt an 80 percent threshold in some cases. Specifically, the final regulations should retain the rule of the Proposed Regulations that would provide that a payment obligation will not be recognized unless the partner or related person is or would be liable up to the full amount of that partner's or related

114 Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F).

115 If this recommendation is not adopted, it will be necessary to make conforming changes to various parts of the existing regulations, as well as to certain parts of other recently proposed regulations under section 752, which recognize vertical slice guarantees. *See* Prop. Treas. Reg. § 1.752-2(a)(2), Prop. Treas. Reg. § 1.752-2(f) *Example 9*. In addition, if this recommendation is not adopted, the final regulations also presumably should include an aggregation rule or other guidance on what are considered separate liabilities. For example, assume that X and Y each contribute \$50 to a partnership and the partnership borrows \$100 pursuant to a conventional bank loan. One-half, or \$50, of the loan is held by Bank One, and the other \$50 of the loan is held by Bank Two. X guarantees the liability owed to Bank One, and Y guarantees the liability owed to Bank Two. As a general matter, the liabilities owed to Bank One and Bank Two are treated as different liabilities and different indebtedness, even if they were part of the same "issue" under the rules generally governing the taxation of debt instruments. *Cf.*, *supra*, note 112 and related text.

person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied. Nevertheless, the final regulations should provide that a payment obligation will be respected if a partner or related person (i) is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, less than 80 percent of the partnership liability is not otherwise satisfied and (ii) either (A) the taxpayer or the IRS clearly establishes that the credit support materially decreased the partnership's borrowing costs with respect to the liability or materially enhanced the other terms of the borrowing,[116] or (B) the partners (or persons related to one or more of the partners), in the aggregate, are or would be liable up to the full amount of their payment obligations if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.[117] We believe that this somewhat lower threshold, applicable only in limited situations, recognizes the fact that such a credit support provider may have meaningful risk with respect to the underlying liability, while protecting the legitimate interests of the government in ensuring that this lower threshold is not abused by taxpayers.

Fifth, a deficit restoration obligation (a "DRO") can in many ways function like a guarantee. That is, like a guarantee, a DRO can expose a partner to liability for partnership obligations and, as a result, can attract the allocation of liabilities under section 752. Therefore, the final regulations should make clear that the provisions relating to bottom-dollar guarantees also apply to DROs and similar arrangements. Although it might be possible to draft detailed rules to address DROs, we instead recommend that the final regulations simply clarify that a DRO is to be treated as a guarantee or similar arrangement for purposes of Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F). It will also be necessary for the regulations under section 704(b) to be amended to make clear that if a DRO is not given effect under section 752, it will not be given effect under the section 704(b) regulations. In this regard, we note that, in our experience, the typical DROs would not satisfy each and every Payment Obligation Requirement. Therefore, if the Proposed Regulations are not substantially modified, in the future, DROs would not attract allocations of liabilities and would not support the allocation of deductions under section 704(b). (This latter point is discussed in more detail in Part III.C., below.)

g. Indemnities, Reimbursement Agreements, or Similar Arrangements

Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G) would require:

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116 *Cf.* Treas. Reg. § 1.707-3(c)(2) (presumption that transfers within a two-year period of property to a partnership and money or other consideration to the partner constitute a sale may be rebutted if the facts and circumstances clearly establish that the transfers do not constitute a sale).

117 Thus, for example, assume that X and Y are equal members of LLC, which has borrowed $100 from an unrelated lender. X and Y each guarantee repayment of the entire $100 (including interest), and their guarantees are otherwise recognized for tax purposes. X and Y agree that, as between themselves, X is obligated to make a payment only to the extent the lender receives less than $80 (plus interest). Under our proposal, X's and Y's payment obligations would be respected. In addition, an argument can be made that so long as 100 percent of the debt is supported by a "real" obligation of at least one partner, the entire debt should be treated as recourse regardless of how the partners determine to share that obligation (that is, without regard to the 80 percent limitation recommended above). *Cf.*, *infra*, note 121.

> In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied. The indemnity, reimbursement agreement, or similar arrangement only satisfies this paragraph (b)(3)(ii)(G) if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefitted party's payment obligation is recognized under [§ 1.752-2(b)(3)] or would be recognized under [§ 1.752-2(b)(3)] if such person were a partner or related person. For purposes of this paragraph (b)(3)(ii)(G), the terms of an indemnity, reimbursement agreement, or similar arrangement will be treated as modified by any further right of indemnity, reimbursement, or similar arrangement regardless of whether that further arrangement would be recognized under [§ 1.752-2(b)(3)]. However, the preceding sentence does not apply to a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

As this Payment Obligation Requirement serves the same function for indemnities, reimbursement agreements, and similar arrangements as Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) serves for guarantees, our comments are the same. In addition, we recommend that Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) and (G) be combined into a single paragraph.

C. Interaction with Section 704

As noted above, the Treasury regulations under section 704(b) and section 752 have been drafted and are intended to work together.[118] Because it is not clear that DROs are treated as a guarantee or other arrangement under the Proposed Regulations, the Proposed Regulations could be interpreted as "de-linking" the section 704(b) regulations from the section 752 regulations. It strikes us as unlikely that a de-linking was intended, and we recommend that the final regulations make clear that a DRO is treated as a guarantee or other arrangement, thereby reaffirming the linkage between the two sets of regulations.[119]

This rather technical recommendation, however, could obscure the fact that, as significant as the impact of the Proposed Regulations would be on section 752, their impact will

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118 *See* T.D. 8237, 53 Fed. Reg. 53140 (Dec. 30, 1988) (referring to "the coordination of the economic risk of loss analysis employed in sections 704(b) and 752").

119 The IRS and Treasury may want to consider conforming the definition of "nonrecourse liability" in Treas. Reg. § 1.752-1(a)(2) with the definition in Treas. Reg. § 1.1001-2(a)(4)(i). This issue has been recognized since 1991 in the preamble to the final regulations regarding allocations attributable to partnership nonrecourse liabilities. T.D. 8385, 56 Fed. Reg. 66978 (Dec. 27, 1991). *See generally* Karen Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations*, 57 Tax Lawyer 33 (2003).

perhaps be just as great on the allocation of debt-financed partnership deductions. Given that this impact is not made clear in the Proposed Regulations and is not even discussed in the preamble, many members of the tax community have expressed surprise, confusion, and concern, and we share their concern. A simple example highlights the significant change in allocations that would result if the Proposed Regulations were finalized.

> **Example 6**. X, Y, and Z form a limited partnership, LP, with X contributing $20 for a 20 percent general partner interest, and Y and Z each contributing $40 for a 40 percent limited partner interest. LP borrows $300 from an unrelated lender on a full recourse basis and buys a depreciable asset from an unrelated person. Under the limited partnership agreement, X has a DRO that obligates X to contribute additional capital to LP to satisfy its creditors to the extent that the fair market value of LP's assets is insufficient to do so. This DRO is treated as a limited DRO that satisfies the requirements of Treas. Reg. § 1.704-1(b)(2)(ii)(*c*) as described in Rev. Rul. 97-38;[120] but the DRO would not satisfy the Payment Obligation Requirements because X is not obligated to provide any documentation or maintain any particular net worth; nor is X paid for providing the DRO.
>
> Under both current law and the Proposed Regulations, the first $100 of depreciation deductions from the asset would be allocated to the members in proportion to their interests. Under current law, the remaining $300 of depreciation deductions would be allocated entirely to X. Under the Proposed Regulations, however, the remaining $300 of depreciation would be allocated to the members in proportion to their interests under Treas. Reg. § 1.704-2. This is the case even though X actually would be obligated to pay the lender if LP does not do so.

The results in Example 6 are not surprising from a technical point of view. That is, under existing law, X's DRO causes LP's liability to be recourse under section 752, and X is allocated the deductions under Treas. Reg. § 1.704-1. Under the Proposed Regulations, the DRO would not cause LP's liability to be recourse. Therefore, the liability would be nonrecourse and the associated deductions would be allocated to the partners under Treas. Reg. § 1.704-2. (Similar issues could arise as a result of the application of the Proposed Regulations relating to bottom-dollar guarantees.)

Consider also the following example.

> **Example 7**. X and Y form a limited partnership, LP, with each contributing $50, and each agreeing to a $50 DRO. LP borrows

[120] 1997-2 C.B. 69. In all examples in this report, except as the context otherwise requires, the relevant partnership agreement satisfies the primary or alternate test for economic effect in Treas. Reg. § 1.704-1(b)(2)(ii)(*b*) and (*d*), respectively, and the allocations are substantial within the meaning of Treas. Reg. § 1.704-1(b)(2)(iii).

$100 from an unrelated lender and buys a depreciable asset from an unrelated person. Under the limited partnership agreement, the first $100 of losses is allocated equally to X and Y, the next $50 of losses is allocated entirely to X, and the last $50 of losses is allocated entirely to Y.

LP incurs $50 of losses in each of years 1 through 4, for a total of $200 of losses. LP allocates the losses in years 1 and 2 equally to X and Y. LP allocates the $50 of losses in year 3 to X and the $50 of losses in year 4 entirely to Y. Under current law and the Proposed Regulations, the allocation of the first $100 of losses equally to X and Y would be respected.

Under current law (including the liquidation at section 704(b) book value analysis of Rev. Rul. 97-38), the allocations in years 3 and 4 also would be respected. That is, at the end of year 3, X would be treated as having a $50 DRO that would support the allocation of the $50 of year 3 losses to X. Similarly, at the end of year 4, Y would be treated as having a $50 DRO that would support the allocation of the $50 of year 4 losses to Y.

It seems that the allocation in year 3 would be respected under the Proposed Regulations for the same reasons (and because X's payment obligation is not in effect a bottom-dollar guarantee). It appears, however, that the allocation in year 4 would not be respected under the Proposed Regulations; rather, it appears that the losses in year 4 would be treated as nonrecourse deductions that would have to be allocated under Treas. Reg. § 1.704-2.[121] (Once again, similar issues could arise as a result of the application of the Proposed Regulations relating to bottom-dollar guarantees.)

The results in Examples 6 and 7 would represent a fundamental change in the actual allocation of partnership deductions, and it is a change that, as noted above, was not discussed in the preamble to the Proposed Regulations and is not described in the Proposed Regulations themselves. For these reasons, we strongly recommend that the IRS and Treasury consider not finalizing any portion of the Proposed Regulations relating to section 752, instead finalizing only the regulations under section 707, as described in Part IV below, and also strengthening the anti-abuse rule of Treas. Reg. § 1.752-2(j). If this is done, we further recommend that the government seek comments from the tax community regarding the issues under section 704.

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[121] The facts of Example 7 are in some sense very similar to the first part of Example 5, in which the Proposed Regulations would treat all of the debt as recourse. In both situations, the entire partnership debt is supported by a real obligation of one or more partners. The difference in the examples relates to the economic arrangement among the partners about the manner in which losses are to be shared. In Example 5, X and Y bear all losses proportionally, whereas in Example 7, X bears a portion of the losses before Y.

D. The Net Value Rules

The Proposed Regulations would expand the Net Value Rules currently applicable to disregarded entities to payment obligations generally, other than payment obligations of individuals and decedents' estates.[122] Although we support this proposal and make certain suggestions below, an expansion of the rule would add considerable burden and expense for many taxpayers and seems likely to lead to time consuming and costly disputes regarding valuations.[123] Moreover, it would involve more partner-level interactions with the IRS, which does not seem to be a particularly successful enforcement area for the IRS. If, as we have recommended, all liabilities were treated as nonrecourse for purposes of section 707, then the expansion of the Net Value Rules may not be necessary, particularly if the anti-abuse rule of Treas. Reg. § 1.752-2(j) were strengthened to make its reach clearer to taxpayers and advisors who may have interpreted it too narrowly.

The IRS and Treasury specifically requested comments regarding (i) whether the final regulations should extend the Net Value Rules to all partners and related persons, (ii) whether it would be clearer if all the net value rules were consolidated in Treas. Reg. § 1.752-2(k), and (iii) the application of the Net Value Rules to tiered partnerships. We address these issues below.

First, the IRS and Treasury requested comments on whether the final regulations should extend the Net Value Rules to all partners and related persons. We have interpreted this request to be asking whether to apply the Net Value Rules to individuals and decedents' estates, and we recommend that the Net Value Rules be extended to all partners and related persons other than individuals. We are concerned, however, that Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(C), which would require that the partner who may be treated as bearing the EROL for a partnership liability provide information regarding the net value of the credit support provider, is vague and would be unnecessarily intrusive. Therefore, we recommend that this requirement be modified to require instead that the partner be required to make a representation regarding the net value of the credit support provider. If the partner fails to provide a representation, the credit support provider would be treated as having a net worth of zero. (The IRS and Treasury should consider the "optionality" this would permit taxpayers in classifying liabilities as nonrecourse.)

Second, we believe that the regulations would be clearer if all the Net Value Rules were consolidated in Treas. Reg. § 1.752-2(k). We recommend that the final regulations do this by extending the Net Value Rules to all partners and related persons (other than individuals) rather than by retaining the existing regulatory framework of initially assuming that all parties will satisfy their obligations regardless of their net worth, having a special rule for disregarded entities, and then treating partners and related persons as disregarded entities.

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[122] Prop. Treas. Reg. § 1.752-3(b)(3)(iii)(B).

[123] We note that, in measuring net value by excluding the value of the partner's interest in the partnership, the Proposed Regulations, although consistent with the constructive liquidation test of Treas. Reg. § 1.752-2(b)(1), arguably impose stricter standards than lenders typically impose. That is, lenders do not disregard the value of the assets acquired with the proceeds of a loan.

Third, to address the application of the net value rules of Prop. Treas. Reg. § 1.752-2(b)(3)(iii)(B) to tiered partnerships, we recommend that the final regulations include an anti-avoidance provision similar to Treas. Reg. § 1.705-2(c)(1), which provides that the purpose of those regulations "cannot be avoided through the use of tiered partnerships or other arrangements."

E. Rights to Reimbursement

Under the current regulations, the amount of a partner's EROL is reduced by the amount the partner or a related person would be entitled to be reimbursed by another partner or person that is related to another partner.[124] Prop. Treas. Reg. § 1.752-2(b)(1) would extend the reach of this rule by reducing the amount of a partner's EROL by the amount the partner is entitled to be reimbursed by "any person."[125] The effect of the proposed rule is demonstrated by the following example.

> **Example 8**. LLC borrows $100 from an unrelated bank. To reduce the interest rate that the bank would otherwise charge on the loan, Y, a member of LLC, guarantees repayment of the loan pursuant to a guarantee that satisfies all of the requirements of the Proposed Regulations. To reduce its economic exposure under its guarantee, Y enters into a credit default swap with X, an unrelated financial institution. Under the terms of the credit default swap, X is obligated to reimburse Y for any payments it makes to bank under the guarantee of LLC's borrowing.[126]

Under current law, Y would be treated as bearing the EROL for the bank debt, because X is not a partner in LLC and is not related to a partner in LLC. Under the Proposed Regulations, however, Y would not be treated as bearing the EROL, which would cause the liability to be a nonrecourse liability.

Although we are in principle supportive of the proposed extension, we believe that Prop. Treas. Reg. § 1.752-2(b)(1) likely is broader than the IRS and Treasury intended. Read literally, the reimbursement rule in the Proposed Regulations would prevent a partner from bearing the EROL for a liability if the partner is entitled to reimbursement from a person related *to that partner*. It is doubtful that this result was intended because the related person rules in the section 752 regulations usually work *the other way*. Thus, for example, if a person related to a partner lends to the partnership, the liability would be allocated to that partner.

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124 Treas. Reg. § 1.752-2(b)(1).

125 As noted above, the preamble states that the IRS and Treasury "have concluded that any source of reimbursement that effectively eliminates the partner's payment risk should cause a payment obligation to be disregarded. Therefore, the proposed regulations change the rule in § 1.752-2(b)(1) to reduce the partner's payment obligation by the amount of any right to reimbursement from any person." 79 Fed. Reg. 4831.

126 X's and Y's payment obligations satisfy all provisions of the Proposed Regulations.

Additionally, the reimbursement rule in the Proposed Regulations would seem to apply to a reimbursement obligation from *the partnership* to a partner. This also seems incorrect because, under the constructive liquidation test that is used for determining whether a partner bears the EROL for a partnership's liabilities, all of the partnership's assets are deemed to be worthless. Thus, a right to be reimbursed by the partnership would have no value and should not affect the determination of the extent to which a partner bears the EROL for a partnership's liabilities. Therefore, the final regulations should provide that the rule generally does not apply to a right to be reimbursed by the partnership or by a person related to the person who has a right to be reimbursed.

There is, however, at least one situation in which the right to be reimbursed by the partnership should perhaps be treated as reducing a partner's EROL for a partnership liability. Specifically, we recommend that the final regulations clarify the extent, if any, to which the rule would apply if the partnership obtains credit support that is intended to (or has the effect of) reducing a credit support provider's economic risk with respect to one or more partnership liabilities, as in the following example.

> **Example 9**. LLC borrows $100 from an unrelated bank. To reduce the interest rate that the bank would otherwise charge on the loan, LLC pays X, an unrelated financial institution, to guarantee repayment of the loan. Y, a member of LLC, also guarantees repayment of the loan. Should LLC default on the loan, X bears the obligation to pay the bank, without any reimbursement from Y.[127]

Perhaps the results in Example 9 are the same as in Example 8, although reaching this result requires concluding that the right to reimbursement from the financial institution will have value, which is inconsistent with the constructive liquidation test of Treas. Reg. § 1.752-2(b). It would be helpful for the final regulations to address this fact pattern.

F. Interest on Nonrecourse Liabilities

Treas. Reg. § 1.752-2(e) provides that, for purposes of Treas. Reg. § 1.752-2, if one or more partners or related persons have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership nonrecourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the liability is treated as two separate partnership liabilities.[128] The IRS and Treasury specifically requested comments on whether this special rule (and related Treas. Reg. § 1.752-2(f) *Example 7*) should be removed

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127 X's and Y's payment obligations satisfy all provisions of the Proposed Regulations.

128 *See also* Treas. Reg. § 1.752-1(i) ("If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability.").

from the final regulations or revised to require that 100 percent of the total interest that will accrue on a partnership nonrecourse liability be guaranteed.

Consistent with our recommendation regarding vertical slice guarantees, we recommend that this portion of the existing regulations remain unchanged.

G. Nonrecourse Liabilities

As noted above, the Proposed Regulations would modify Treas. Reg. § 1.752-3(a)(3) by removing the Significant Item Method and the Alternative Method. Thus, partnerships would be permitted to allocate excess nonrecourse liabilities only under the Remaining 704(c) Method and/or in accordance with the partners' interests in partnership profits. To provide some measure of certainty regarding the partners' interest in partnership profits, the Proposed Regulations would provide that "the partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are in accordance with the partners' liquidation value percentages."

As an initial matter, if the concern motivating the proposed changes to Treas. Reg. § 1.752-3(a)(3) is the attempt by taxpayers and their advisors to exploit those methods in the context of the disguised sale rules, we recommend that the final regulations take a more narrowly tailored approach, specifically leaving Treas. Reg. § 1.752-3(a)(3) as it is, but (i) adding the proposed liquidation value percentage rules (for all purposes), and (ii) prohibiting the use of the Significant Item Method and the Alternative Method for purposes of the disguised sale rules. If, on the other hand, the motivating concern is that the Significant Item Method permits the allocation of nonrecourse liabilities in a manner that is inconsistent with the partners' shares of partnership profits,[129] the IRS and Treasury should revisit Treas. Reg. § 1.704-2(e)(2), which permits "allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities."

In addition, we have five comments regarding the liquidation value percentage rule. First, it is not clear how a partnership is supposed to allocate excess nonrecourse liabilities if the partnership agreement is silent on this issue. Presumably, these liabilities should be allocated under any permissible method selected by the partnership, but clarification would be helpful.

Second, and in a related point, it appears from the text of the Proposed Regulations that the liquidation value percentage approach would be the only permissible method of determining the partners' interests in partnership profits. We understand that this was not intended; rather, it was intended that the liquidation value percentage approach would function as a safe harbor. If so, the text of the final regulations should make this clear. In this regard, we note that the IRS and Treasury have requested comments on methods other than the liquidation value percentage approach that reasonably measure a partner's interest in partnership profits and that are not overly burdensome. We welcome this request and recommend that the

[129] 79 Fed. Reg. 4831.

final regulations permit partnerships to allocate excess nonrecourse liabilities *either* in accordance with partnership profits as reasonably determined by the partnership *or* in accordance with the partners' liquidation value percentages.[130]

Third, the IRS and Treasury requested comments on whether exceptions should be provided to exclude certain events from triggering a redetermination of the partners' liquidation values. In response to this request, we recommend that the final regulations ease the administrative burden on partnerships by not requiring hypothetical revaluations of the partners' capital accounts. Instead, the final regulations should follow the approach of the regulations under section 706, which permit partnerships to "assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts as of the first day of the partnership taxable year."[131] If this approach were adopted, it may be appropriate for the final regulations to contain a specific anti-abuse rule that would apply if a principal purpose of not undertaking the hypothetical revaluation is to affect the allocation of partnership nonrecourse liabilities in a manner that substantially reduces the present value of the partners' aggregate tax liability.

Fourth, we considered whether the liquidation value approach could cause deductions to be inappropriately "trapped" at the partnership level, as demonstrated by the following example:

> **Example 10**. X contributes $100 to LLC. Y is issued an interest for no consideration other than agreeing to render services to LLC. Y enters into a $100 DRO. X and Y are equal members. LLC borrows $100 from Bank and purchases a depreciable asset for $200; the loan from Bank is nonrecourse to LLC and its members and is secured solely by the acquired asset. LLC initially allocates all of the $100 of debt to X because X's liquidation value percentage is 100 percent. (X has all of the capital.) LLC allocates all of the depreciation deductions attributable to the asset to Y.
>
> The allocation of the first $100 of depreciation has substantial economic effect under Treas. Reg. § 1.704-1(b)(2), but Y is unable to claim the depreciation deductions allocated to it because of the basis limitation rule of section 704(d). The allocation of the second $100 satisfies the requirements of Treas. Reg. § 1.704-2, as

130 For purposes of determining the partners' interests in partnership profits, the regulations should permit a partnership to rely on a reasonable estimate of the amounts the partners are expected to receive from the partnership over the life of the partnership. The partnership should be required to revise its estimates each year and should be permitted to do so more frequently, in each case using consistent valuation and liquidation assumptions to the extent doing so is reasonable in light of the facts and circumstances.

131 Treas. Reg. § 1.706-1(b)(4)(iii). The regulation permits this only if the partnership maintains capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv).

> it is consistent with the allocation of the first $100 of depreciation, which had substantial economic effect.
>
> After the asset has been fully depreciated, LLC has $100 of minimum gain because the amount of its liability, $100, exceeds its asset basis, $0, by $100. As Y was allocated all of the nonrecourse deductions, Y's share of LLC's minimum gain is $100.[132] Therefore, the liability will be allocated entirely to Y under Treas. Reg. § 1.752-3(a)(1), which will permit Y to claim $100 of depreciation deductions.

At first blush, it appears inequitable for Y to be unable to claim all $200 of the deductions properly allocated to it. Indeed, the result seems inconsistent with the purpose of section 752, which is to ensure that partners are permitted to claim deductions properly allocable to them under section 704 and recognize gain, if any, under section 704, rather than under section 731.[133] Upon closer inspection, however, the result reached in Example 10 is appropriate. Of the deductions allocated to Y, only $100 are attributable to LLC's nonrecourse liability, and Y is able to claim those deductions. The $100 of "trapped" deductions are attributable to X's equity, and it is appropriate for Y not to be able to claim those deductions.

Finally, we note that there are two ambiguities in the operation of existing Treas. Reg. § 1.752-3 (and its interaction with Treas. Reg. § 1.707-5) that would be helpful to have clarified in connection with finalizing the Proposed Regulations. First, although the liquidation value percentage appears to be a useful safe harbor for many partnerships, it may not properly reflect the partners' interests in the partnership in those partnerships that are not capital intensive, have profits interest partners (as in Example 10), or have more complex capital structures and economic sharing arrangements. To address partnerships with "tracking allocations," for example, we recommend that the final regulations clarify that partners may have more than one interest in a partnership for purposes of allocating excess nonrecourse liabilities, as demonstrated by Example 11.

> **Example 11**. X and Y each contribute $60 to LLC. An unrelated bank lends LLC $40 ("<u>Debt 1</u>"). LLC acquires Business 1 for $100, using the $40 proceeds of Debt 1 and $60 of contributed capital. Debt 1 is secured solely by Business 1. The same bank lends LLC an additional $40 ("<u>Debt 2</u>"). LLC acquires Business 2 for $100, using the $40 proceeds of Debt 2 and the remaining $60 of contributed capital. Debt 2 is secured solely by Business 2.

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132 Treas. Reg. § 1.704-2(g)(1).

133 T.D. 8237, 53 Fed. Reg. 53142 (Dec. 30, 1988) ("The allocation of nonrecourse liabilities among the partners in accordance with their shares of partnership minimum gain and section 704(c) minimum gain coordinates the treatment of nonrecourse liabilities under section 752 with the treatment of nonrecourse liabilities under the section 704(b) regulations. As in the case of recourse liabilities, this reflects the fact that one of the principal purposes for including partnership liabilities in the bases of the partners' interests in the partnership is to support the deductions that will be claimed by the partners for the items attributable to those liabilities.").

> Under the LLC agreement, X is entitled to 90 percent of the profits and losses from Business 1 and 10 percent from Business 2, and, conversely, Y is entitled to 10 percent of the profits and losses from Business 1 and 90 percent from Business 2. The LLC agreement further provides that Debt 1 will be serviced solely by the profits and capital associated with Business 1 and that Debt 2 will be serviced solely by the profits and capital associated with Business 2.

Under current law, specifically under both the Significant Item Method and the Alternative Method, Debt 1 may be allocated 90:10 between X and Y, respectively, and Debt 2 may be allocated 10:90 between X and Y, respectively. We recommend that, in such situations, taxpayers be permitted to allocate Debt 1 and Debt 2 in the same manner under the final regulations.

Tracking allocations can give rise to more complex situations that we suggest the final regulations also address.

> **Example 12**. X and Y each contribute $60 to LLC. An unrelated bank lends LLC $80 (the "Loan"). LLC uses the contributed capital and loan proceeds to acquire Business 1 for $130 and Business 2 for $70. The Loan is secured by all of LLC's assets.
>
> Under the LLC agreement, X is entitled to 90 percent of the profits and losses from Business 1 and 10 percent from Business 2, and, conversely, Y is entitled to 10 percent of the profits and losses from Business 1 and 90 percent from Business 2. The LLC agreement further provides that $60 of the principal and associated interest on the Loan will be serviced solely by the profits and capital associated with Business 1 and that the remaining $20 of the principal and associated interest on the Loan will be serviced solely by the profits and capital associated with Business 2.

Under current law, specifically, under the Significant Item Method, the Loan could be allocated either 90:10 or 10:90 to X and Y, or in any proportions between these two proportions.[134] Although we recognize that the government is interested in limiting the flexibility that taxpayers have under current law, we recommend that the final regulations continue to permit taxpayers to allocate debt in a manner that is consistent with their sharing of the profits of the venture. Thus, if (i) all of the partnership's assets are available to satisfy a liability and (ii) the partners share profits from different businesses in more than one proportion, then that debt should be allocable among the partners in proportion to their shares of profits from any such business (or, perhaps, in any proportion that is in between the sharing ratios for those businesses).

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[134] Treas. Reg. § 1.704-2(m), *Example 1(ii)*.

Second, Treas. Reg. § 1.707-5(a)(2)(ii) and -5(b)(2) reference Treas. Reg. § 1.752-3(a)(3) for purposes of determining a partner's share of a partnership liability. Treas. Reg. § 1.752-3(a)(3), though, specifically prohibits a partnership from using the Remaining 704(c) Method for purposes of Treas. Reg. § 1.707-5. It seems very clear that if a partnership uses the Remaining 704(c) Method for purposes of allocating some or all of its excess nonrecourse liabilities under section 752, then it is the manner in which the partnership allocates (or would allocate) any remaining excess nonrecourse liabilities that is determinative for purposes of Treas. Reg. § 1.707-5. (The failure of Treas. Reg. § 1.707-5 to make this clear likely is explained by the fact the section 707 regulations were promulgated before the Remaining 704(c) Method was added to the section 752 regulations.[135]) It would be helpful for the regulations to be amended to make this clear, perhaps including an example similar to Example 13, below.

> **Example 13**. X contributes an asset with a fair market value of \$70 and adjusted basis of \$65, subject to a \$10 nonqualified liability ("Debt X"), in exchange for a 60 percent LLC interest. Y contributes an asset with a fair market value of \$110 and adjusted basis of \$20, subject to a \$70 qualified liability ("Debt Y"), to LLC in exchange for a 40 percent LLC interest. LLC borrows \$80 from an unrelated bank and satisfies Debts X and Y.[136] LLC's borrowing is properly treated as a nonrecourse liability under Treas. Reg. § 1.752-1(a)(2).
>
> There is no partnership minimum gain (because the amount of the liability, \$80, is less than the section 704(b) basis of LLC's assets, \$180). Therefore, no portion of the liability is allocated under Treas. Reg. § 1.752-3(a)(1). Under Treas. Reg. § 1.752-3(b), for purposes of determining whether there is any "section 704(c) minimum gain," LLC allocates the liability to the assets contributed by X and Y in proportion to their adjusted bases, resulting in no section 704(c) minimum gain, and no allocation of the liability under Treas. Reg. § 1.752-3(a)(2). Under Treas. Reg. § 1.752-3(a)(3), LLC allocates \$50 of the liability to X under the Remaining 704(c) Method, and allocates the remaining \$30 of the liability to X and Y in proportion to their LLC interests (*i.e.*, \$18 to X and \$12 to Y).
>
> To determine whether LLC's taking X's asset subject to the \$10 nonqualified liability will be treated in whole or in part as a

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135 The section 707 regulations were promulgated in 1992. T.D. 8439, 57 Fed. Reg. 44974 (Sept. 30, 1992). The Remaining 704(c) Method was added to the section 752 regulations in 2000. T.D. 8906, 65 Fed. Reg. 64888 (Oct. 31, 2000).

136 Treas. Reg. § 1.707-5(c).

disguised sale,[137] LLC must determine X's and Y's allocable shares of LLC's liability. Because the Remaining 704(c) Method is not available for purposes of Treas. Reg. § 1.707-5(a)(2)(ii), and LLC has no special allocations, the partners' allocable shares of the liability should be determined by reference to their interest in LLC's profits. Thus, for purposes of the disguised sale rules, X's allocable share of the liability is 60 percent ($48), and Y's allocable share of the liability is 40 percent ($32).[138] X's share of the liability before the contributions was $10, and, for purposes of the disguised sale rules, X's share of LLC's liability after the contributions is $48. As X's share of liabilities has not decreased, X is not treated as having received any proceeds in a disguised sale.

H. Transition Rules

As noted above, the Proposed Regulations under section 752 apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the Section 752 Effective Date, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect before that date.[139] The transition rule for partners with a share of a recourse liability immediately before the Section 752 Effective Date would apply for a period of seven years after the effective date of the final regulations.[140] Although we agree that it is appropriate for these rules to apply only when finalized, we have two recommendations.

First, it appears that if a liability is refinanced or significantly modified (so that the modified liability, if a debt instrument, is a new debt instrument under Treas. Reg. § 1.1001-3) or a payment obligation is modified in a manner that causes it to be treated as a new payment obligation for U.S. federal income tax purposes, the liability or payment obligation would become subject to the rules of the final regulations. We recommend that the regulations, when finalized, permit partnership liabilities that are modified and/or refinanced and payment obligations that are modified to continue to be subject to the provisions of the existing regulations but only to the extent of the amount and duration of the pre-modification (or refinancing) liability or payment obligation. Thus, for example, if a $100 liability with a maturity date that is 7 years after the Section 752 Effective were refinanced into a $120 liability with a maturity date that is 8 years after the Section 752 Effective Date, the transition rule would apply only to $100 of the liability and only for the first 7 years; the excess $20 amount would be

137 As Y contributed its assets subject to a qualified liability and received only an LLC interest in exchange, Y is not treated as having received any proceeds in a disguised sale. Treas. Reg. § 1.707-5(a)(5).

138 To determine whether X's share of liabilities has decreased for this purpose, X is permitted to take into account the increase in X's share of Debt Y as well as X's share of Debt X. Treas. Reg. § 1.707-5(a)(4). The refinancing of these debts does not change this computation.

139 Prop. Treas. Reg. § 1.752-2(l)(1).

140 Prop. Treas. Reg. § 1.752-2(l)(2).

subject immediately to the final regulations. The remaining $100 would become subject to the final regulations at the end of the transition period.[141] Without such a rule, the effective date in the Proposed Regulations may discourage partnerships from refinancing liabilities or may subject partners to unexpected adverse results, such as triggering gain under section 731 to a partner whose share of partnership liabilities would be lower under the final regulations than it is under current law.

Second, we recommend that partnerships be permitted to elect to apply all, but not less than all, of the provisions of the final regulations to all of its liabilities and payment obligations with respect to its liabilities. This recommendation would apply to taxable years ending on or after the effective date of the regulations.[142]

IV. Detailed Discussion – Proposed Regulations under Section 707

As described in our Summary of Recommendations and discussed in detail in Part III, above, we recommend that the final regulations take different approaches to the allocation of liabilities for disguised sale purposes than for purposes of section 752. The provisions of the Proposed Regulations addressing section 707 are in many respects severable from those addressing section 752, but the converse is not true. This is because changes made to the allocation of liabilities under section 752 generally impact the allocation of liabilities for disguised sale purposes. Accordingly, this Part IV discusses the portion of the Proposed Regulations under section 707 that operates largely independent of the portion of the Proposed Regulations under section 752, which are discussed in Part III, above.

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141 For a similar rule in the disguised sale context, see Treas. Reg. § 1.707-5(c) (to the extent that the proceeds of a partner or partnership liability (the refinancing debt) are allocable under the rules of Temp. Treas. Reg. § 1.163-8T to payments discharging all or part of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability for purposes of applying Treas. Reg. § 1.707-5). *See also* Temp. Treas. Reg. § 1.163-8T(e)(1) (for purposes of the interest tracing rules, to the extent proceeds of any debt (the "replacement debt") are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated).

142 A rule permitting such an election would be similar to the rule in Treas. Reg. § 1.752-5(b), which permitted a partnership to elect to apply the provisions of Treas. Reg. §§ 1.752-1 through 1.752-4 (as finalized in 1991) to all of its liabilities to which the provisions of those sections did not otherwise apply as of the beginning of the first taxable year of the partnership ending on or after December 28, 1991. If such an election is permitted with respect to the Proposed Regulations when they become final, it may be advisable for the final regulations to specify how the election would apply in a tiered partnership structure. For example, if a lower-tier partnership makes the election, would an upper-tier partnership that is allocated liabilities of the lower-tier partnership be bound by that election with respect to the upper-tier partnership's allocation of those liabilities? If the lower-tier partnership does not make the election, could the upper-tier partnership make the election with respect to the upper-tier partnership's share of lower-tier partnership's liabilities? Additionally, we recommend that the Section 752 Effective Date be moved from Treas. Reg. § 1752-2 to Treas. Reg. § 1.752-5 ("Effective dates and transitional rules"). We also recommend that, with respect to technical terminations under section 708(b)(1)(B), the rule of existing Treas. Reg. § 1.752-5(c) (which provides that "[f]or purposes of applying this section, a termination of the partnership under section 708(b)(1)(B) will not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of the termination.") should apply, rather than the narrower rule of Prop. Treas. Reg. § 1.752-2(l)(2)(ii)(B), and that payment obligations in effect when a partnership technically terminates similarly should not be treated as incurred on the date of the termination.

A. Preformation Capital Expenditures

The Proposed Regulations would provide that the limitation on the preformation capital expenditure exception applies "on a property-by-property basis."[143] We generally support the proposed rule, but note that, in some circumstances, the property-by-property approach would be extremely burdensome for taxpayers to satisfy and the IRS to administer.[144] Therefore, we recommend adding limited aggregation rules, perhaps similar to those in Treas. Reg. § 1.704-3(e)(2), which permits aggregation of certain types of property for purposes of making allocations under section 704(c)(1)(A).[145]

As also noted, the Proposed Regulations would "coordinate" the reimbursement of preformation capital expenditures rule of Treas. Reg. § 1.707-4(d) with the Cap Ex Debt rule of Treas. Reg. § 1.707-5(a)(6). The Proposed Regulations would achieve this coordination by providing that:

> if the capital expenditures were funded by a liability defined in § 1.707-5(a)(6)(i)(C) that is assumed or taken subject to by the partnership in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership to the partner exceeds the partner's share of the liability (as determined under § 1.707-5(a)(2)).

> As described in the preamble, the IRS and Treasury are aware
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> that taxpayers are uncertain about whether a partner may qualify

143 Prop. Treas. Reg. § 1.707-4(d)(1)(ii)(B).

144 As noted above, the Proposed Regulations do not provide any guidance regarding how to identify a single piece of property. As a result, despite the additional clarity provided by the proposed rule, the proper identification of a single piece of property will continue to be a source of uncertainty for taxpayers. For example, if the owner of a pipeline makes improvements to its existing pipeline, presumably those improvements are part of the same property for this purpose. But what if the owner adds a new "branch" to the pipeline? Is that part of the same property? Courts and the IRS have addressed this issue in other contexts. *See AmeriSouth XXXII Ltd. v. Commissioner*, T.C. Memo 2012-67 (discussing whether certain property was part of an apartment building and should be classified as residential real property or was made up of components that should be classified as tangible personal property for depreciation purposes); PLR 201049029 (May 7, 2010) (discussing whether a "programming package" should be treated as a single property for purposes of determining whether receipts were domestic production gross receipts under section 199(c)(4)(A)(i)(II)); PLR 200902011 (Sept. 30, 2008) (determining the "single, identifiable property" by reference to which the taxpayer's storm casualty losses should be determined under section 165). More recently, the IRS and Treasury issued proposed regulations providing guidelines for determining whether a separately identifiable item of property is a distinct asset for purposes of applying certain requirements applicable to REITs. *See* REG-150760-13, Definition of Real Estate Investment Trust Property, 79 Fed. Reg. 27508 (May 14, 2014). The final regulations could permit partnerships to address this issue using any reasonable method, consistently applied.

145 We considered whether a special rule, like that in Treas. Reg. § 1.362-4(g)(12)(ii), would be appropriate when the contributed property is an interest in another partnership and concluded that no special rule is required.

> under the exception for preformation capital expenditures if those expenditures were funded with a capital expenditure qualified liability. For example, taxpayers are uncertain about whether a partner can finance its capital expenditures through a borrowing that is exempted as a qualified liability and can also be reimbursed for those expenditures without triggering sale treatment. The IRS and the Treasury Department believe that the exception for preformation capital expenditures applies only to the extent the distribution is in reimbursement of such expenditures. Thus, the proposed regulations provide that to the extent a partner funded a capital expenditure through a borrowing and economic responsibility for that borrowing has shifted to another partner, the exception for preformation capital expenditures should not apply because there is no outlay by the partner to reimburse.[146]

Perhaps more to the point is that taxpayers have taken the position that a partner may do exactly that. This position, commonly referred to as a "double dip," has been well-understood by taxpayers for decades, having been apparently sanctioned by the IRS in a 1994 private letter ruling.[147]

In PLR 9444004, a corporation that operated two business lines formed a partnership with an unrelated third-party investor. The corporation contributed one of its business lines, subject to certain liabilities, and the investor contributed cash, to the partnership. Within two years preceding the transfer, the corporation made capital expenditures with respect to property such as parts, machinery, and equipment, in connection with the contributed business line. The partnership agreement provided that to the extent certain future cash contributions to the partnership exceeded the liabilities transferred to the partnership by the corporation, that cash would be distributed to the corporation with respect to the corporation's preformation capital expenditures. The corporation requested rulings that both of the exceptions to the disguised sale rules found (i) in Treas. Reg. § 1.707-4(d) for preformation capital expenditures and (ii) in Treas. Reg. § 1.707-5(a) for qualified liabilities apply to any future distributions to the corporation.

The IRS concluded that, for purposes of applying the preformation capital expenditure exception under Treas. Reg. § 1.707-4, the corporation's capital expenditures with respect to the property contributed to the partnership "include the amount of capital expenditures incurred by [taxpayer] … not reduced by any liabilities."[148] The IRS ruled further that the corporation's qualified liabilities included certain liability assumed (or taken subject to) by the partnership that were allocable under the rules of Temp. Treas. Reg. § 1.163-8T to capital expenditures with respect to property contributed by the corporation to the partnership. Thus,

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146 79 Fed. Reg. 4828.

147 PLR 9444004 (Nov. 9, 1993); *see also*, Gregory J. Marich & Barksdale Hortenstine, *A Comprehensive Guide to Interpreting and Living With the Rules Governing Disguised Sales of Property*, 110 Tax Notes 1421, 1459 (Mar. 27, 2006). Note that, under section 6110(k)(3), letter rulings may not be used or cited as precedent.

148 PLR 9444004 (Nov. 4, 1993).

although the PLR does not explicitly sanction the corporation's receiving two economic benefits (*i.e.*, cash distributions to reimburse it for preformation capital expenditures and assumption of liabilities the proceeds of which were used to fund those capital expenditures), the language in the conclusion of the PLR suggests that the IRS considered whether the preformation capital expenditure exception under Treas. Reg. § 1.707-4 and the qualified liability exception under Treas. Reg. § 1.707-5 could be applied with respect to the same economic outlay.

The Proposed Regulations would foreclose this planning opportunity. The operation of this proposed rule can be demonstrated by the following example.

> **Example 14**. On January 30, 2013, X borrows $100 from unrelated lender, uses the proceeds of the loan to make substantial capital improvements to Asset, and treats the capital improvements made to Asset as having been made from the proceeds of the borrowing under Temp. Treas. Reg. § 1.163-8T.[149] In late 2014, when Asset has a gross fair market value of $1,000 and an adjusted basis of $600, X contributes Asset, subject to the liability, to LLC[150] in exchange for a 10 percent interest in LLC and $100 in cash that is treated as a reimbursement of the capital improvements made to Asset. LLC allocates $10 of the liability to X under Treas. Reg. § 1.752-3(a)(3).
>
> Under current law, the liability is a qualified liability under Treas. Reg. § 1.707-5(a)(6)(i)(C).[151] In addition, LLC's transfer of $100 to X qualifies as a reimbursement of X's capital expenditures with respect to Asset.[152] It appears that, under current law, X may avail itself of both exceptions to disguised sale treatment, which has the effect of giving X $190 of economic benefit (net decrease in debt of $90 and actual receipt of $100 cash) for $100 of cash outlay (the capital improvements made to Asset). Prop. Treas. Reg. § 1.707-4(d)(2) would treat only $10 of the reimbursement as a qualified reimbursement. Thus, the economic benefit to X would be limited to $100 (net decrease in debt of $90, and reimbursement of $10).

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149 Under Temp. Treas. Reg. § 1.163-8T(c)(4)(iv)(B), as modified by Notice 89-35, 1989-1 C.B. 675, the taxpayer may treat expenditures made from an account within only 30 days after debt proceeds are deposited in the account as made from the proceeds even if under the general ordering rule the debt proceeds would be treated as used to make one or more other expenditures.

150 LLC is classified as a partnership for U.S. federal income tax purposes. Unless noted otherwise, all unincorporated entities referred to in this report are classified as partnerships for U.S. federal income tax purposes.

151 The liability is qualified because the proceeds of the borrowing were used to make capital improvements to Asset.

152 Treas. Reg. § 1.707-4(d). X made $100 of capital expenditures within two years before the transfer to LLC with respect to Asset, which was contributed to LLC. The fair market value of Asset exceeds 120 percent of the partner's adjusted basis in Asset at the time of contribution to LLC. As a result, the 20-percent limitation contained in Treas. Reg. § 1.707-4(d)(2)(ii) applies; the amount of the reimbursement, however, is within the limit.

> The remaining $90 of the reimbursement, *i.e.*, the portion of the liability that exceeds X's 10 percent share of the liability, would not qualify under Treas. Reg. § 1.707-4(d).[153]

This coordination has been expected since the promulgation of the now-withdrawn proposed regulations addressing the disguised sale of partnership interests.[154] We agree that a taxpayer should not be permitted to treat a liability assumed by a partnership as a qualified liability under Treas. Reg. § 1.707-5(a)(6)(i) and at the same time be reimbursed under Treas. Reg. § 1.707-4(d) for the outlay of cash that was funded with the proceeds of that liability.

We note, however, that the Proposed Regulations, by focusing narrowly on Cap Ex Debt, do not appear to fully foreclose the "double dip" potential that can arise from the interaction of the qualified liability rules and the rules relating to the reimbursement of preformation capital expenditures. Consider the following example.

> **Example 15**. On January 15, 2013, X, a corporation, borrows $100 from unrelated lender. The borrowing is secured by Asset.

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153 As a result, the $90 would, absent another applicable exception, constitute proceeds in a disguised sale of a portion of Asset to LLC. It should be noted that this could cause a portion of the qualified liability to be "tainted" under the net equity percentage rule of Treas. Reg. § 1.707-5(a)(5).

154 In Notice 2001-64, 2001-2 C.B. 316, the IRS requested comments on "the scope and substance" of guidance to be proposed concerning disguised sales of partnership interests and received a number of comments in response. *See*, *e.g.*, New York State Bar Association Tax Section, *Report on Disguised Sales of Partnership Interests Responding to Notice 2001-64* (Feb. 13, 2003), *reprinted in* 2003 TNT 44-15; Section of Taxation of the American Bar Association, *Comments on Disguised Sales of Partnership Interests*, 2004 TNT 65-73 (Apr. 2, 2004). In 2004, the IRS and Treasury published proposed regulations under section 707(a)(2)(B) addressing disguised sales of partnership interests (the "Proposed DSPI Regulations"). REG-149519-03, 69 Fed. Reg. 68838 (Nov. 26, 2004). In general, the proposed regulations applied to certain situations in which one or more persons contributed cash or property to a partnership and the partnership made distributions of cash or property to one or more of the existing partners. The preamble to the Proposed DSPI Regulations stated:

> The IRS and the Treasury Department have become aware of certain deficiencies and technical ambiguities in the existing regulations under § 1.707-3, 1.707-4, 1.707-5 and 1.707-6. Among the deficiencies and technical ambiguities identified are the rules for capital expenditure reimbursements, the liability sharing rules, and the interaction of the capital expenditure reimbursement rules with the qualified liability rules. In order to address these deficiencies and technical ambiguities, the IRS and the Treasury Department intend to issue proposed regulations amending the existing regulations. In addition, the IRS and the Treasury Department intend to revise these proposed regulations to reflect those proposed amendments to the existing regulations. The IRS and Treasury Department request comments on the scope and content of the revisions to the existing regulations (and these proposed regulations).

69 Fed. Reg. 68843. The Proposed DSPI Regulations were met with heavy criticism from commentators. *See*, *e.g.*, Section of Taxation of the American Bar Association, *Comments Concerning Disguised Sales of Partnership Interests*, 2005 TNT 146-46 (July 29, 2005); New York State Bar Association Tax Section, *Report on Disguised Sales of Partnership Interests* (Apr. 22, 2005), *reprinted in* 2005 TNT 78-42. In 2009, the IRS and Treasury withdrew the Proposed DSPI Regulations, stating that they will continue to study this area and may issue guidance in the future. Section 707 Regarding Disguised Sales, Generally, 74 Fed. Reg. 3508 (Jan. 21, 2009); *see also* Ann. 2009-4, 2009-1 C.B. 597. Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership are transfers of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law. 74 Fed. Reg. 3509.

> X promptly distributes the $100 to its shareholders. On January 30, 2013, X spends $100 to make substantial capital improvements to Asset, and X does not treat the capital improvements made to Asset as having been made from the proceeds of the borrowing. In late 2014, X is approached by unrelated LLC about the possibility of LLC's acquiring Asset. X and LLC negotiate the terms of the acquisition, and on January 5, 2015, X contributes Asset, subject to the liability, to LLC in exchange for a 10 percent interest in LLC and $100 in cash that is treated as a reimbursement of the capital improvements made to Asset. LLC allocates $10 of the liability to X.
>
> Under current law, the liability is a qualified liability under Treas. Reg. § 1.707-5(a)(6)(i)(B).[155] In addition, LLC's transfer of $100 to X qualifies as a reimbursement of X's capital expenditures with respect to Asset.[156] It appears that, under current law, X may avail itself of both exceptions to disguised sale treatment, which has the effect of giving X $190 of economic benefit (net decrease in debt of $90 and actual receipt of $100 cash) for $100 of cash outlay (the capital improvements made to Asset). Prop. Treas. Reg. § 1.707-4(d)(2) would not preclude this result, however, because the proposed regulation is, by its terms, limited to Cap Ex Debt.

Therefore, although we are supportive of Prop. Treas. Reg. § 1.707-4(d)(2), we recommend that it be broadened to apply the same rule to capital expenditures funded by any qualified liability.[157] For this purpose, capital expenditures should be treated as "funded by" the proceeds of a particular qualified liability to the extent (i) the proceeds of the liability are traced under Temp. Treas. Reg. § 1.163-8T to the capital expenditures or (ii) the proceeds were actually used to fund the capital expenditures, regardless of whether the timing requirements of Temp. Treas. Reg. § 1.163-8T are satisfied. The final regulations should include a broadly drafted anti-abuse rule that would apply if planning is undertaken with respect to a liability and capital expenditures with a principal purpose of circumventing the purposes and requirements of Prop. Treas. Reg. § 1.707-4(d)(2).

In addition to broadening Prop. Treas. Reg. § 1.707-4(d)(2), we recommend a clarification. The rule contained in Prop. Treas. Reg. § 1.707-4(d)(2) permits a reimbursement

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155 The liability is qualified because it was not incurred in anticipation of the transfer of the Asset to LLC, but it was incurred within the two-year period prior to the transfer of Asset to LLC and has encumbered Asset since it was incurred. Thus, treatment of the liability as a qualified liability must be disclosed in accordance with Treas. Reg. § 1.707-8. Treas. Reg. § 1.707-5(a)(7)(ii).

156 Treas. Reg. § 1.707-4(d). X made $100 of capital expenditures within two years before the transfer to LLC with respect to Asset, which was contributed to LLC. Assume the $100 reimbursement is within the applicable limitations in Treas. Reg. § 1.707-4(d).

157 We note that the references to "contributed" property in Treas. Reg. § 1.707-4(d)(2)(ii) ought to be references to "transferred" property.

of a debt-funded capital expenditure to the extent of the transferring partner's share of the liability under Treas. Reg. § 1.707-5(a)(2). It arguably is not clear whether the partner's share of the liability for this purpose would take into account an anticipated reduction as described in Treas. Reg. § 1.707-5(a)(3). We believe the regulations should clarify that a partner's share of the liability in Prop. Treas. Reg. § 1.707-4(d)(2) should be "determined under Treas. Reg. § 1.707-5(a)(2), taking into account Treas. Reg. § 1.707-5(a)(3)."

B. Tiered Partnerships

The Proposed Regulations would add two additional rules addressing tiered partnerships. As noted by the preamble, the existing regulations have limited rules applicable to tiered partnerships.[158] The Proposed Regulations would clarify that the debt-financed distribution rules of Treas. Reg. § 1.707-5(b) apply to distributions through tiers of partnerships. This rule is sensible and in line with how most practitioners have applied the existing regulations, and we support it.[159]

According to the preamble, the second proposal, Prop. Treas. Reg. § 1.707-5(e)(2):

> provide[s] rules regarding the characterization of liabilities attributable to a contributed partnership interest. Section 752(d) provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. Accordingly, a partner that contributes an interest in a partnership (lower-tier partnership) to another partnership (upper-tier partnership) must take into account its share of liabilities from the lower-tier partnership in applying the rules under [Treas. Reg.] § 1.707-5.[160]

Under current law, it is not clear how liabilities of a lower-tier partnership should be treated when an interest in the lower tier is contributed to an upper-tier partnership. A number of approaches have been discussed by commentators, including: (i) disregarding the liabilities of the lower-tier partnership altogether and (ii) treating, under a variety of approaches, the liabilities of the lower-tier partnership as liabilities of the transferring partner to the extent of the partner's

158 79 Fed. Reg. 4829. The existing rules regarding tiered partnerships are found in Treas. Reg. § 1.707-5(e).

159 The Proposed Regulations do not expressly address the application of the § 1.707-5(a) Liability Netting Rule, the cash netting rule of Treas. Reg. § 1.707-5(d), or the application of Treas. Reg. § 1.707-4(d) to contributions and distributions of lower-tier partnership interests. Based on the language in the preamble, aggregate treatment would apply in these situations as well.

160 79 Fed. Reg. 4829.

interest in the lower-tier partnership.[161] The Proposed Regulations would adopt a form of the second approach:

> The IRS and the Treasury Department believe it is appropriate to treat the lower-tier partnership as an aggregate for purposes of determining whether the upper-tier partnership's share of the liabilities of the lower-tier partnership are qualified liabilities. Thus, these proposed regulations provide that a contributing partner's share of liabilities from a lower-tier partnership are treated as qualified liabilities to the extent the liability would be a qualified liability had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership.[162]

Specifically, under the Proposed Regulations:

> If an interest in a partnership that has one or more liabilities (the lower-tier partnership) is transferred to another partnership (the upper-tier partnership), the upper-tier partnership's share of any liability of the lower-tier partnership that is treated as a liability of the upper-tier partnership under § 1.752-4(a) is treated as a qualified liability under § 1.707-5(a)(6)(i) to the extent the liability would be a qualified liability under § 1.707-5(a)(6)(i) had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership.[163]

Although we are supportive of this proposal, we believe it would be helpful for the final regulations to add some details regarding this determination. For example, in determining whether a liability is Nonanticipatory Debt, intention at the time the debt is incurred is relevant. Consider the following examples.

> **Example 16**. X is a 10 percent member in LLC. LLC borrows $100 from an unrelated bank (giving the bank a security interest in its assets), allocates the liability under Treas. Reg. § 1.752-3(a)(3) to its members in proportion to their interests, and distributes the debt proceeds in the same proportions. The next day, X contributes its interest in LLC to LLC 2 in exchange for an interest in LLC 2.

[161] For further discussion of this issue, see Mark Opper, *Can Lower-Tier Partnership Liabilities Be Treated as Proceeds of a Disguised Sale?* 16 J. Passthrough Entities 7 (Nov.-Dec. 2013).

[162] 79 Fed. Reg. 4829.

[163] Prop. Treas. Reg. § 1.707-5(e)(2).

> Under the Proposed Regulations, to determine the extent to which LLC 2's taking the LLC interest subject to X's share of the liability is treated as part of a disguised sale, the liability would be characterized in the same manner as if LLC had transferred its assets, subject to the liability, to LLC 2. In this case, it would appear that the liability could constitute a qualified liability only if it could be established that it was a Nonanticipatory Debt or In Connection With Debt, for which intention is also relevant.

We believe that, as X is the party that potentially would be treated as engaging in a disguised sale, it should be X's intention that is relevant, and we recommend that the final regulations make clear whose intention is relevant in making this determination. In Example 16, if X anticipated the transfer to LLC 2 when LLC borrowed the $100, X's share of the liability would not be a qualified liability. If, however, X did not anticipate doing so, X's share of the liability should constitute Nonanticipatory Debt. The following fact pattern is perhaps even more sympathetic.

> **Example 17**. The facts are the same as in Example 16, except that X sells its interest to Y, which subsequently contributes the acquired LLC interest to LLC 2. The debt-financed distribution by LLC and the sale by X to Y are not part of a single, integrated plan.

It is not clear how the rule in the Proposed Regulations would apply to Y, who was not a member of LLC when the debt was incurred. We believe, though, that Y's share of LLC's liability should constitute Nonanticipatory Debt and may well also constitute Cap Ex Debt. We recommend that the final regulations include an example making these points.

In addition, we recommend that the final regulations confirm that if property is transferred in a nonrecognition transaction, and the transferee assumes a qualified liability of the transferor or takes the property subject to a qualified liability, the liability retains its status as a qualified liability in the hands of the transferee. Similarly, we recommend that the final regulations confirm that if a taxpayer incurs preformation capital expenditures with respect to property and transfers the property in a nonrecognition transaction, the transferee succeeds to the status of the transferor with respect to those expenditures. (Consideration should be given to how to apply such a rule to nonrecognition transactions in which some gain is recognized, such as transactions qualifying under section 351(a) in which the transferor recognizes gain under section 351(b).) These rules would be consistent with Treas. Reg. § 1.707-5(e) of the existing regulations,[164] as well as with Rev. Rul. 2000-44.[165]

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[164] Treas. Reg. § 1.707-5(e) provides that "[i]f a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the characterization as qualified or nonqualified that it had under these rules in the upper-tier partnership. A similar rule applies to other related party transactions involving liabilities to the extent provided by guidance published in the Internal Revenue Bulletin."

[165] 2000-2 C.B. 336 (Oct. 10, 2000) (a corporation that acquires assets in a transaction covered by section 381(a) will succeed to the status of the transferor corporation for purposes of (i) applying Treas. Reg.

C. Assets-Over Partnership Mergers

Treas. Reg. § 1.752-1(f), which provides for "netting" of increases and decreases in a partner's share of liabilities resulting from a single transaction, specifically addresses assets-over partnership mergers, providing that "[w]hen two or more partnerships merge or consolidate under section 708(b)(2)(A), as described in § 1.708-1(c)(3)(i), increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under section 752." This language would appear to be broad enough to permit (or require) netting for purposes of the disguised sale rules. Prop. Treas. Reg. § 1.707-5(f) would specify, however, that when two or more partnerships merge or consolidate, "any increases or decreases in partnership liabilities associated with the merger or consolidation are netted by a partner in the terminating partnership and the resulting partnership for purposes of applying §§ 1.707-3 through 1.707-5 to transfers of money or other consideration by the terminating partnership to the partner."

The preamble does not explain the problem or uncertainty that the proposed rule is intended to address. It is possible, however, that it is directed at the following fact pattern:

> **Example 18**. X and Y are equal partners in Target LLC, which has assets and nonqualified liabilities. Unrelated Acquiror LLC is worth substantially more than Target. Acquiror LLC also has liabilities. Target LLC contributes all its assets and its nonqualified liabilities to Acquiror LLC in exchange for a 40 percent interest in Acquiror LLC and liquidates, distributing Acquiror LLC interests equally to X and Y. After the merger, the former liabilities of Target LLC and the pre-merger liabilities of Acquiror LLC are shared by all of the members in Acquiror LLC, the continuing partnership, under section 752 and the regulations thereunder.

As discussed above, the § 1.752-1 Liability Netting Rule in the current regulations appears to protect the terminating partnership from recognizing gain under section 731(a) as the result of a deemed distribution from the continuing partnership under section 752(b). Presumably, the intent of the corresponding language in the Proposed Regulations likewise is to prevent a reduction in the terminating partnership's share of debt from causing a disguised sale of property between the terminating partnership and the continuing partnership. Yet it is not clear how the language of the Proposed Regulations is intended to address the facts of Example 18.[166] Therefore, it would be helpful if the language were modified to make its coverage broad

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§ 1.707-4(d), and (ii) determining whether liabilities that were incurred by the transferor corporation should be treated as qualified liabilities in the hands of the transferee corporation).

166 Suppose, for example, that the partners in the terminating partnership have an aggregate decrease in their shares of partnership liabilities and that all of the terminating partnership's liabilities are nonqualified liabilities, resulting in a disguised sale. Would the resulting sale be treated as occurring between the terminating partnership and the continuing partnership? What if only one partner has a decrease in its share of partnership liabilities? Would the resulting partial sale be treated as occurring between the terminating partnership and the continuing partnership? If so, would the gain be allocated only to the partner whose share of partnership liabilities decreased?

enough to address those facts. In addition, because, as noted above, the preamble does not describe the concern that this part of the Proposed Regulations would address, it would be helpful for final regulations to have a number of examples, including (i) an example that illustrates the concern that prompted the rule in the Proposed Regulations, (ii) an example that illustrates the application of the rule to the facts of Example 18, and (iii) an example in which partners in the terminating partnership are also partners in the surviving (or continuing) partnership.[167]

Although not directly raised by the Proposed Regulations, an interesting issue can arise in assets-over mergers in which the target partnership interests were acquired with debt. Consider the following example.

> **Example 19**. X and Y buy all of Target LLC, funding the acquisition with their own cash and fully recourse debt. Later, X and Y contribute all of their Target LLC interests, subject to the acquisition debt, to Acquiror LLC in exchange for 40 percent of the interests in Acquiror LLC and Acquiror LLC's assumption of the acquisition debt.

Under the partnership merger regulations, the transaction in Example 19 will be treated as an assets-over transaction because those regulations do not recognize "interests-over" transactions.[168] As a result, Target LLC would be treated as transferring all of its assets to Acquiror LLC in exchange for Acquiror LLC interests and liquidating. There are at least two constructs to explain how the acquisition debt is assumed by Acquiror LLC, but the concern in both constructs is that the related contribution and assumption of debt could be treated as a disguised sale. First, the acquisition debt could be treated as assumed by Target LLC immediately before the merger and transferred to Acquiror LLC in the merger. To avoid a disguised sale, it would be necessary to treat the assumed liability as a qualified liability in the hands of Target LLC. Second, the acquisition debt could be treated as assumed by Acquiror LLC immediately after the merger. Under this construct, to avoid a disguised sale, it would be necessary to treat Target LLC's transfer of assets and Acquiror LLC's assumption of X's and Y's liabilities as unrelated, which seems to be a difficult position to sustain.

In certain situations, it might be possible for X and Y to structure the transaction as an "assets-up" merger, in which Target LLC liquidates and then X and Y transfer assets, subject to the acquisition liabilities, to Acquiror LLC. In that event, under the substitution rules of Temp. Treas. Reg. § 1.163-8T(j), the acquisition liabilities would become qualified liabilities with respect to Target LLC's former assets, and, thus, Acquiror LLC's assumption of those

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[167] Recall that, under the § 1.707-5(a) Liability Netting Rule, each partner that contributes property to a partnership is permitted to offset that partner's nonqualified liabilities against other liabilities assumed or taken subject to by the partnership pursuant to a plan. The partners, however, are not permitted to offset their nonqualified liabilities against the partnership's pre-existing liabilities (*i.e.*, liabilities that are not assumed or taken subject to as part of a plan). The proposed § 1.707-5(f) Liability Netting Rule is more generous than the § 1.707-5(a) Liability Netting Rule because it appears to allow the partners in the terminating partnership to offset their nonqualified liabilities against their shares of the continuing partnership's pre-existing liabilities.

[168] Treas. Reg. § 1.708-1(c)(3).

liabilities would not be treated as proceeds in a disguised sale. It is not always possible to structure mergers as assets-up transactions, however. Moreover, as a matter of sound tax policy, it seems inappropriate for debt that is plainly a qualified liability to be transformed into a nonqualified liability merely because of a regulatory recast (*i.e.*, the assets-over recast). Therefore, we recommend that the Proposed Regulations, when finalized, provide that, in an assets-over partnership merger, qualified liabilities of one or more partners in a terminating partnership that are assumed or taken subject to by the continuing partnership will be treated as qualified liabilities of the terminating partnership for purposes of applying the disguised sale rules to the merger.[169]

D. Contingent Liabilities

The Proposed Regulations would delete a portion of the definition of the term "liability" from the existing disguised sale regulations. The language of existing Treas. Reg. § 1.707-5(a)(2), with the language that would be deleted in bold, is set forth below:

> (i) A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under § 1.752-1(a)(1) **or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section**.
>
> (ii) A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability of the partnership under § 1.752-1(a)(2) **or would be a nonrecourse liability of the partnership under § 1.752-1(a)(2) if it were treated as a partnership liability for purposes of that section**.

(Emphasis added.) The history of this regulation does not provide very much insight into its meaning. When the disguised sale regulations were proposed in 1991, the term liability was defined as "any obligation of a person that is considered a liability under general principles of Federal tax law without regard to the limitations provided in § 1.752-1T(g)."[170] When the

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169 The rule should apply to actual assets-over transactions, as well as to interests-over mergers that are recast as assets-over mergers.

170 Former Prop. Treas. Reg. § 1.707-5(a)(2)(i). Temp. Treas. Reg. § 1.752-1T(g) provided:

> (g) *Liability defined*. Except as otherwise provided in the regulations under section 752, an obligation is a liability of the obligor for purposes of section 752 and the regulations thereunder to the extent, but only to the extent, that incurring or holding such obligation gives rise to –
>
> (1) The creation of, or an increase in, the basis of any property owned by the obligor (including cash attributable to borrowings);
>
> (2) A deduction that is taken into account in computing the taxable income of the obligor; or
>
> (3) An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. See examples (2) and (3)(ii) of paragraph (k) of this section.

disguised sale regulations were finalized in 1992, however, the IRS and Treasury deleted that definition (without explanation).[171]

Nearly 13 years later, in the preamble to the final Treas. Reg. § 1.752-7 regulations, the IRS and Treasury expressly addressed the interaction of contingent liabilities and the disguised sale rules:

> Section 1.752-7(a)(2) of the proposed regulations provides that the assumption of a § 1.752-7 liability is not treated as an assumption of a liability or as a transfer of cash for purposes of section 707(a)(2)(B). One commentator noted that the language contained in the proposed regulations was not consistent with § 1.707-5(a), which takes into account all liabilities, regardless of whether those liabilities are taken into account under section 752.
>
> The intent of the proposed regulations under section 752 was not to override the disguised sale rules under section 707, which may include § 1.752-7 liabilities as consideration. Therefore, § 1.752-7(a)(2) has been removed.[172]

Thus, it seems clear that, at least in 2005, the IRS and Treasury believed that contingent liabilities *are* taken into account under the disguised sale rules. Similarly, we believe that contingent liabilities should be treated in the same manner for deemed (*i.e.*, disguised) sales as for actual sales. We understand that the deletion in the Proposed Regulations was proposed because it was believed that, since the section 752 regulations were amended in 2005 to define specifically contingent liabilities, the language proposed to be deleted was no longer necessary. Because, however, Treas. Reg. § 1.707-5(a)(2) refers to the definition of a "liability" in Treas. Reg. § 1.752-1, it arguably does not include contingent liabilities, which are not defined as liabilities in Treas. Reg. § 1.752-1, but instead are defined in that regulation as "obligations." It

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Later, the IRS issued Rev. Rul. 88-77, 1988-2 C.B. 128, which defined the term liability for purposes of section 752 in the same manner. When the temporary regulations under section 752 were finalized, this definition of the term "liability" was removed. T.D. 8380, 56 Fed. Reg. 66348 (Dec. 23, 1991). In 2005, the section 752 regulations were amended to include this definition. T.D. 9207, 70 Fed. Reg. 30334 (May 26, 2005).

[171] T.D. 8439, 57 Fed. Reg. 44974 (Sep. 30, 1992). Although some commentators believed that the deletion "suggested that contingent liabilities would not be taken into account in applying the disguised sale rules," those commentators pointed out that "the preamble to the final regulations regarding the treatment of contingent liabilities under section 752 indicates that contingent liabilities are taken into account in applying the disguised sale rules. That conclusion is evidently based on the fact that, as described below, the disguised sale regulations define both recourse and nonrecourse liabilities cryptically to include liabilities that would be recourse or nonrecourse, as the case may be, under reg. section 1.752-1 if the liabilities were partnership liabilities." Gregory J. Marich & Barksdale Hortenstine, *A Comprehensive Guide to Interpreting and Living With the Rules Governing Disguised Sales of Property*, 110 Tax Notes 1421, 1467 (Mar. 27, 2006).

[172] T.D. 9207, 70 Fed. Reg. 30339 (May 26, 2005).

would be helpful if the final regulations clarified how contingent liabilities should be treated for purposes of the disguised sale rules.[173]

E. Disguised Sales of Property to Partners

Although the focus of substantially all of the regulations under section 707(a)(2)(B) is disguised sales of property by partners to partnerships, disguised sales can run the other direction. Treas. Reg. § 1.707-6 addresses these types of transactions, largely by incorporating by reference the provisions of Treas. Reg. §§ 1.707-3, -4, and -5. In particular, under Treas. Reg. § 1.707-6(b)(1), if a partner assumes or takes property subject to a liability (other than a qualified liability), the amount treated as consideration transferred to the partnership is the amount by which the liability assumed or taken subject to by the partner exceeds the partner's share of that liability immediately before the transfer. As a result, as noted in the preamble, under the existing regulations,

> if a transferee partner had a 100 percent share of a liability immediately before a transfer in which the transferee partner assumed the liability, then no sale is treated as occurring between the partnership and the partner with respect to the liability assumption, irrespective of the period of time during which the partnership liability is outstanding and the period of time in which the partnership liability is allocated to the partner.[174]

The government believes that it may be "inappropriate" to apply the regulations as currently drafted "if the transferee partner did not have economic exposure with respect to the partnership liability for a meaningful period of time before appreciated property is distributed to that partner subject to the liability."[175] Although the preamble does not give an example of the types of transactions that concern the government, it seems likely that the following are relevant examples. The first, Example 20, involves an anticipatory shift of debt under section 752; the second, Example 21, involves a new borrowing.

> **Example 20**. X is a 1 percent member in LLC, and X's LLC interest is worth $1. LLC owns two assets, Asset 1, with a fair market value of $50, and Asset 2, with a fair market value of $100. LLC also has two loans payable – one in the principal amount of $1, and the other in the principal amount of $49. Both loans are

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173 It would be helpful if the final regulations contained an example of precisely how contingent liabilities should be taken into account. For example, the final regulations could provide guidance regarding how to determine the extent to which a contingent liability constitutes a qualified liability. In addition, although it seems that contingent liabilities should be shared in the manner in which the deductions or expenditures resulting from the satisfaction of those liabilities would be allocated among the partners, confirmation and clarification would be helpful.

174 79 Fed. Reg. 4829.

175 *Id.*

nonrecourse liabilities under Treas. Reg. § 1.752-1(a)(2), and X's share of the loans under Treas. Reg. § 1.752-3(a)(3) is $0.50.

X would like to own Asset 1, and LLC is interested in disposing of it. Therefore, LLC distributes Asset 1, and X assumes the $49 liability, in liquidation of X's LLC interest.[176]

The treatment of the distribution in Example 20 depends initially on the status of the $49 liability as a qualified or nonqualified liability. If the liability is a qualified liability under Treas. Reg. § 1.707-6(b), the distribution is tax free to X and LLC under section 731. If, though, the liability is not a qualified liability, then the treatment of the distribution depends on X's share of the liabilities before and after the distribution. As noted above, X's share of LLC's liabilities before the distribution was $0.50, and X's share of those liabilities after the distribution is $49. As a result, X would be treated as purchasing a portion of Asset 1 in exchange for assuming a portion of the liability ($48.50, the excess of the amount of the liability, $49, over X's 1 percent share of the liabilities of LLC before the distribution, $0.50).[177] X would be treated as receiving the balance of Asset 1 in a tax-free distribution under section 731.

It appears, however, that, under current law, X and LLC can avoid this result by causing the entire liability to be allocated to X "immediately before" the distribution, perhaps by X's guaranteeing repayment of the liability. In that event, no portion of the distribution would be treated as a sale because the regulations look to the excess of the amount of the liability assumed over the distributee's share of the liability "immediately before" the distribution.[178]

The second concern is illustrated by the following example.

Example 21. X is a 1 percent member in LLC, and X's LLC interest is worth $2. LLC owns two appreciated assets, Asset 1,

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[176] For purposes of analysis, assume that the distribution is tax free under section 731 except to the extent that section 707(a)(2)(B) and Treas. Reg. § 1.707-6 apply to treat the distribution in whole or in part as a sale of Asset 1 to X. Depending on the facts, LLC might be required to adjust the basis of its remaining assets under section 734(b).

[177] The calculation in the text gives X and LLC "credit" for X's share of all of LLC's liabilities before the distribution because we believe a liability netting rule similar to the § 1.707-5(a) Liability Netting Rule should apply by virtue of the cross reference in Treas. Reg. § 1.707-6 to Treas. Reg. § 1.707-5. If this were not the case, the disguised sales proceeds would be $0.01 greater ($48.51, the excess of the amount of the assumed liability, $49, over X's 1 percent share of only the $49 liability before the distribution, $0.49).

[178] Treas. Reg. § 1.707-6(b)(1). The strength of this potential planning technique is not entirely clear because it places considerable pressure on a narrow interpretation of the phrase "immediately before." In this regard, it should be noted that the phrase "immediately after," which is used most notably in sections 351(a) and 368(a)(1)(B), has been interpreted using the step transaction doctrine (or variants of it) to take into account actions that occur sometime later. *See*, *e.g*., *Intermountain Lumber Co.*, 65 T.C. 1025 (1976) (binding obligation by incorporator to sell 50 percent of stock broke section 351control); *West Coast Marketing Corp.*, 46 T.C. 32 (1966) (purported section 368(a)(1)(B) reorganization held to be a taxable exchange of assets for stock); Rev. Rul. 70-140, 1970-1 C.B. 73 (incorporation followed by planned exchange of stock for stock of public company broke section 351 control).

with a fair market value of \$50, and Asset 2, with a fair market value of \$150.

X would like to own Asset 1, and LLC is interested in disposing of it. Therefore, LLC borrows \$48 from an unrelated third party. X guarantees repayment of the liability. Sometime later, LLC distributes Asset 1 to X, and X assumes the \$48 liability, in liquidation of X's LLC interest. LLC retains the proceeds of the borrowing.

In Example 21, the liability is a nonqualified liability, but, under existing law, there is no disguised sale because X's share of the liability is \$48 from the date on which the liability was incurred.[179] Therefore, the distribution is tax free to X and LLC.[180]

Perhaps in light of situations like these, the preamble states that

[the IRS and Treasury] are considering, and request comments on, whether the rules under § 1.707-6 should be amended to provide that a transferee partner's share of an assumed liability immediately before a distribution is taken into account for purposes of determining the consideration transferred to the partnership only to the extent of the partner's lowest share of the liability within some meaningful period of time, for example, 12 months.

The concern highlighted by Example 20 is conceptually identical to (although factually the inverse of) the concern policed by the anticipated reduction rule of Treas. Reg. § 1.707-5(a)(3) (as proposed to be modified by Prop. Treas. Reg. § 1.707-5(a)(3)). Under that rule, a partner's share of a nonqualified liability "immediately after" the partnership's assumption of a liability generally is determined by taking into account anticipated reductions in the partner's share of the liability. The concern addressed by the anticipated reduction rule is transitory and artificially high shares of partnership debt that are intended to reduce the amount of a disguised sale. The concern in Example 20 is essentially the same. Therefore, we recommend that final regulations add to Treas. Reg. § 1.707-6 an "increase in anticipation of transfer" rule similar to the anticipated reduction rule of Treas. Reg. § 1.707-5(a)(3). (Like its counterpart in Treas. Reg. § 1.707-5, the rule in Treas. Reg. § 1.707-6 would be applicable only to nonqualified liabilities.)

179 If there is insufficient time in between the date on which LLC incurs the liability and the date on which X assumes the liability, the transaction would be vulnerable to attack under current law on the grounds that LLC should not be respected as the borrower. In that event, X would be treated as having borrowed \$48 and transferred the proceeds to LLC in exchange for an aliquot portion of Asset 1. Other lines of attack may exist as well. *Cf.* Former Prop. Treas. Reg. § 1.707-7(j)(8) (anti-abuse rule in the withdrawn proposed regulations addressing the disguised sales of partnership interests that appears to have been concerned with such a transaction).

180 Depending on the facts, LLC might be required to adjust the basis of its remaining assets under section 734(b).

The potential abuse highlighted by Example 21 seems to have more to do with the rather transitory nature of LLC's liability for the debt. For this reason, we recommend that final regulations provide that (i) if a partnership incurs a liability in anticipation of distributing an asset to a partner subject to the new liability, and (ii) the partnership retains the proceeds of the liability (or distributes the proceeds to another partner), the new liability assumed or taken subject to by the distributee partner is treated as consideration for the sale of property to the partner to the extent the liability assumed or taken subject to by the distributee partner exceeds any associated decrease in the partner's share of pre-existing partnership liabilities remaining in the partnership.[181]

We acknowledge that, if our recommendations are accepted, there would be different treatment of contribution transactions (*e.g.*, debt-financed distributions under Treas. Reg. § 1.707-5) and distribution transactions (under Treas. Reg. § 1.707-6). We believe, however, that the two transactions are sufficiently different to justify the disparate treatment. Specifically, in a contribution transaction, the recipient of the borrowed cash, *i.e.*, the contributing partner, has continuing economic risk of loss with respect to the assumed liability. This is not the case with a distribution transaction, in which the recipient of the borrowed cash, *i.e.*, the partnership, has no continuing economic risk of loss of any kind with respect to the liability because the liability has been assumed by the distributee partner.

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[181] Once again, we have assumed that a liability netting rule similar to the § 1.707-5(a) Liability Netting Rule applies by virtue of the cross-reference in Treas. Reg. § 1.707-6 to Treas. Reg. § 1.707-5. If a distribution is a liquidating distribution, the distributee's share of partnership liabilities will be reduced to zero.